Core Fixed Income is Dead? Not so Fast.

At a bond conference in New York this month, the phrase "core fixed income is dead" was repeated. Often, in fact. Given today's extreme low nominal interest rates and the fear that real interest rates could be negative for years to come, many investors and consultants are questioning the need for core fixed income. Understandably, the low yields of investment grade portfolios create a temptation to search for more yield and to take more risk. But before racing down the path to yield, one should consider the question: why do I own fixed income? With apologies to Mark Twain, we believe "reports of the death of core bonds have been greatly exaggerated."

There has been a huge proliferation of new fixed income product over the last five years. Developing bond markets overseas, developing derivative markets, and the creativity of hedge fund managers have led to fixed income sub asset classes that did not exist before or, if they did exist, had limited liquidity. At the same time, the Federal Reserve's quantitative easing program has successfully increased the demand for alternative fixed income. Specifically, emerging market debt, high yield bonds, leveraged loan funds, and fixed income hedge funds have experienced large inflows as investors seek higher yield, floating rate structures, and the hard to achieve absolute return.

With the evolution of product in the fixed income market, an evolution in goals for fixed income investing has also occurred. Traditionally, bond investors purchased bonds for income and because the asset class behaved differently from stocks. Thanks to the complex menu of fixed income offerings available today, many bond investors seek out fixed income products for growth and diversification. But with greater complexity comes greater "equity-like" risks. In fact, many of the products in today's fixed income universe behave much more like stocks than bonds. In the following matrix, we examine the correlation behavior of various fixed income subsectors compared to the U.S. Treasury Index.

Correlations to the Barclays U.S. Treasury Index:
(Periods ended 12/31/12)

	3 Year	5 Year	10 Year
Richmond Capital Core Broad*	+0.92	+0.53	+0.68
Merrill Lynch High Yield Index	-0.67	-0.69	-0.50
Credit Suisse Leveraged Loan Index	-0.81	-0.78	-0.66
Citigroup Emerging Mkts Sovereign Index	-0.15	-0.42	-0.05
BarclayHedge Fixed Income Arbitrage Index	-0.56	-0.67	-0.59
HFRI Fixed Income Asset Backed Index	-0.49	-0.66	-0.53
S&P 500 Index	-0.80	-0.67	-0.53

Source: PSN Database
*Core Broad is an actively managed investment grade composite benchmarked to the Barclays Aggregate Index.

With correlations, one can always argue over the appropriate time period to utilize. However, regardless of period, the Core Broad product is positively correlated to Treasuries. Meanwhile, similar to the S&P 500, the other fixed income sectors are actually negatively correlated to Treasuries. Remember that correlation is the tendency of asset classes to vary together. Based on the consistently negative correlations in this matrix, it appears that the "non-core" fixed income classes do vary together. Just not together with bonds!

Before accepting the idea that core fixed income is dead and jumping into alternative fixed income classes, a bond investor should remember two key questions. First, which type of investor am I? Am I the traditional "defensive" fixed income investor or am I a "growth" fixed income investor? The second important question is actually just another way to solve the problem. What am I trying to diversify? Am I trying to diversify my bond holdings or am I trying to diversify my equity holdings (and the plan as a whole)? If your goal is to diversify your equities, keep the correlation matrix in mind and remember that many fixed income choices do not actually perform like fixed income. Be careful not to depart from fixed income in the interest of trying to diversify fixed income. It is possible that adding fixed income diversification might actually decrease overall plan diversification.

There are other considerations to take into account when thinking about the question of core versus alternative fixed income. Am I taking on more "equity-like" risk elsewhere in the portfolio already? If so, the importance of the core "defensive" component of the portfolio could be larger, not smaller. Also, bonds are traditionally a portfolio's deflation hedge. How important is that deflation hedge? Lastly, investors should remember that asset allocation is difficult to time and works best over long periods.

Today, low or negative bond returns are commonly forecast by Wall Street economists. These estimates are very difficult to square with plan payout requirements and discount assumptions. It is no wonder that so many investors are tempted to take on risk in this environment. However, core bonds provide portfolios with an important service beyond just income. They behave differently than stocks. Look no further than 2008 for solid evidence of that fact.

Fixed Income Data Bank

Index Returns

	Qtr.	1 Yr.	3 Yr.
Barclays Aggregate	-0.12%	3.77%	5.48%
Barclays Int. Aggregate	0.15%	3.04%	4.62%
Barclays Govt/Credit	-0.16%	4.56%	5.98%
Barclays Int. Govt/Credit	0.26%	3.53%	4.65%
Barclays 1-3 Year G/C	0.20%	1.10%	1.65%
Barclays 1-10 Year TIPS	0.33%	3.89%	6.20%

Source: Barclays *As of March 31, 2013*

Treasury Market Yields

	3/31/13	12/31/12
3 Month	0.07%	0.04%
2 Year	0.24%	0.25%
5 Year	0.76%	0.72%
10 Year	1.85%	1.76%
30 Year	3.10%	2.95%

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