Independent Financial Advice and Planning

in association with BROOKS MACDONALD

Navigating volatile markets: harnessing the bond-equity partnership

In this article, we take a closer look at the relationship between bonds and equities and how we can use it to our advantage during periods of market volatility.

Triggering market volatility

Financial markets never stay still and can often shoot higher or lower in response to major global events or when economic uncertainty arises. These events can spur markets to move sharply, creating 'market volatility'.

What does that mean for investments?

Understandably, investors may be concerned about the resilience of their portfolios when market volatility arises. The good news is that not all types of investment (or 'asset classes') react in the same way at the same time. There is no guarantee that the investments that perform well one year will perform well the next. Creating a well-diversified portfolio of investments across different geographies, asset classes and sectors is a way to balance risk and reward, designed to help smooth volatility over time.

Bonds versus equities

Equities (investments in a company) and bonds (investments in the debt of a company or government) are two of the most popular asset classes. They are often combined to form a well-diversified portfolio.

Equities generally provide higher returns over the longer term than bonds but also carry higher levels of risk. While bonds appear more complex than equities, they are considered less risky because they provide a regular income and a predetermined return on investment over a specific horizon. History has shown that bonds typically act as a cushion during times of market stress and can serve as a pressure-release valve for investors fleeing from the equity market.

Traditionally, a portfolio combines equities, bonds, and cash. Depending on risk tolerance, the mix of assets can be extended to include allocations to alternative investments such as hedge funds, real estate, infrastructure, or commodities. Constructing a portfolio with different asset types is called 'asset allocation'.

Market stress

The relationship between bonds and equities is not always perfect. Since the Global Financial Crisis of 2007-2008, central banks worldwide have distorted bond markets by buying government bonds regardless of yield and increasing prices.

While these central bank's 'quantitative easing' measures may have helped rescue the broader global economy, they blurred the relationship between bonds and equities. While still out of the ordinary, bond and equity prices can often move in the same direction which is called a positive correlation.

This correlation can also be true in times of severe market stress when markets believe that the risks of buying bonds has increased enough to be more aligned with equities' risk. However, history shows this correlation often snaps back quickly when it reaches extreme levels.

A balancing act

A disciplined approach to asset allocation can ensure that adjustments can be made in response to changing conditions. When bond valuations rise, this provides an opportunity to increase equity exposures at more attractive levels while locking in gains in bond holdings. Equally, the reverse is also true.

Within an equity allocation, it is possible to dial the risk up or down. Investing in emerging markets can often provide high return potential but increased volatility. Size matters, too. Equity investments in small and mid-cap companies carry greater risk and more price volatility than larger, more established companies.

When markets are judged overly optimistic, equities' valuations can move up to levels that are harder to justify. At times like this, there is an opportunity to rebalance away from equities and selectively add to bonds.

We can also judge which type of bonds to buy within a bond allocation. For example, the prospects for bonds issued by different companies and governments may diverge at various points, or the attraction between shorter-dated and longer-dated bonds will sometimes differ. It is prudent to steer appetite between the two to manage risk.

> Accessing different asset classes and actively adjusting the allocations as the environment changes are crucial for effective portfolio management.

Our active diversification

While the bond and equity relationship is often complementary, it is rarely static. Accessing different asset classes and actively adjusting the allocations as the environment changes are crucial for effective portfolio management.

We aim to actively position our clients' portfolios with the most appropriate mix of assets given our outlook and a prespecified level of risk tolerance. The size of each 'allocation' we make in a portfolio is tailored according to the amount of risk it can take to meet its investment goals.

Our objective is not to wait for the perfect opportunity to invest by trying to 'time the market'. Our preferred approach is to apply an asset allocation framework to portfolios where our investment managers regularly rebalance and refocus portfolios according to our clients' needs and prevailing market circumstances.

Key takeaway

While volatile markets can be unsettling, it is important to remember the usually complementary partnership between bonds and equities. Together with careful management, they can build resilience into portfolios. Determining what mix of bonds and equities largely depends on individual goals, risk tolerances, and investment horizons while having the flexibility to take advantage of investment opportunities as they arise.

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