

The fixed income dilemma

A tough spot for bond investors

If you want a level of protection from a market decline, fixed income investments have traditionally been a potential solution. And, during times of volatility, it is no surprise that investors turn to bonds. However, this approach is not as safe as you may think.

With interest rates at record lows, the ability of bonds to provide income, capital appreciation, and most importantly, act as a portfolio ballast in times of stress is fundamentally challenged.

It's time to reevaluate fixed income investing. **Let's get started.**



Three major risks — all stemming from the extremely low interest rate environment — have been pushing bonds out of their “safety” position:

1

**Shrinking
yield cushion**

2

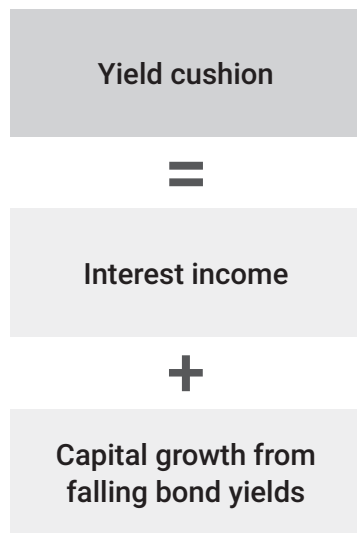
**Rising interest
rate risk**

3

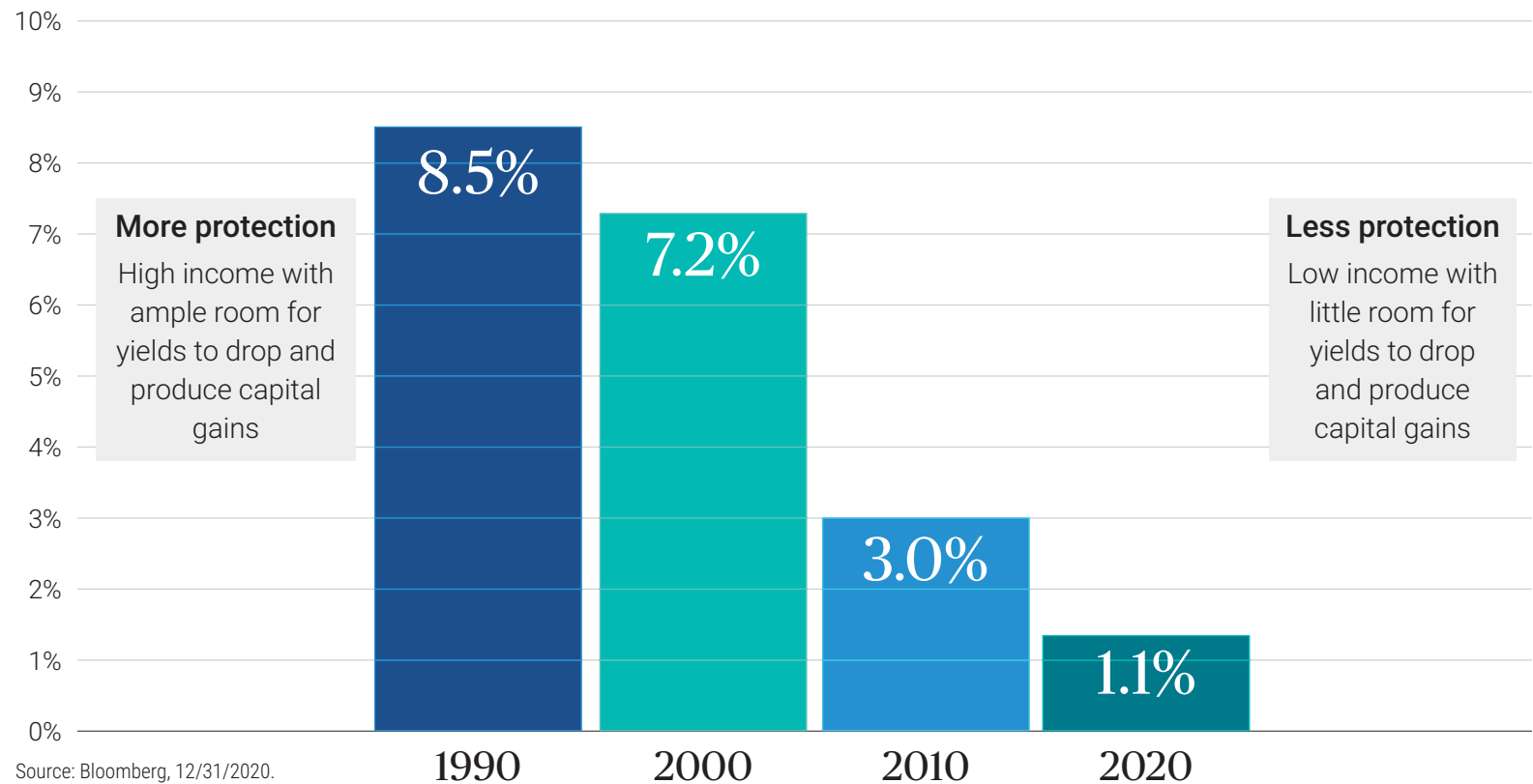
**Increasing
credit risk**

Can you count on bonds to cushion a fall?

With today's historically low interest rates combined with potentially limited capital growth from falling bond yields, fixed income may not provide the same protection against equity losses that it once did.



Bloomberg Barclays U.S. Aggregate Bond Index yield comparison: 1990 vs. today



Is the reward worth the risk?

Since the financial crisis, interest rate risk has been rising while yields have been falling. And that creates a poor risk/reward trade-off for fixed income and leaves portfolios very vulnerable to rising rates.

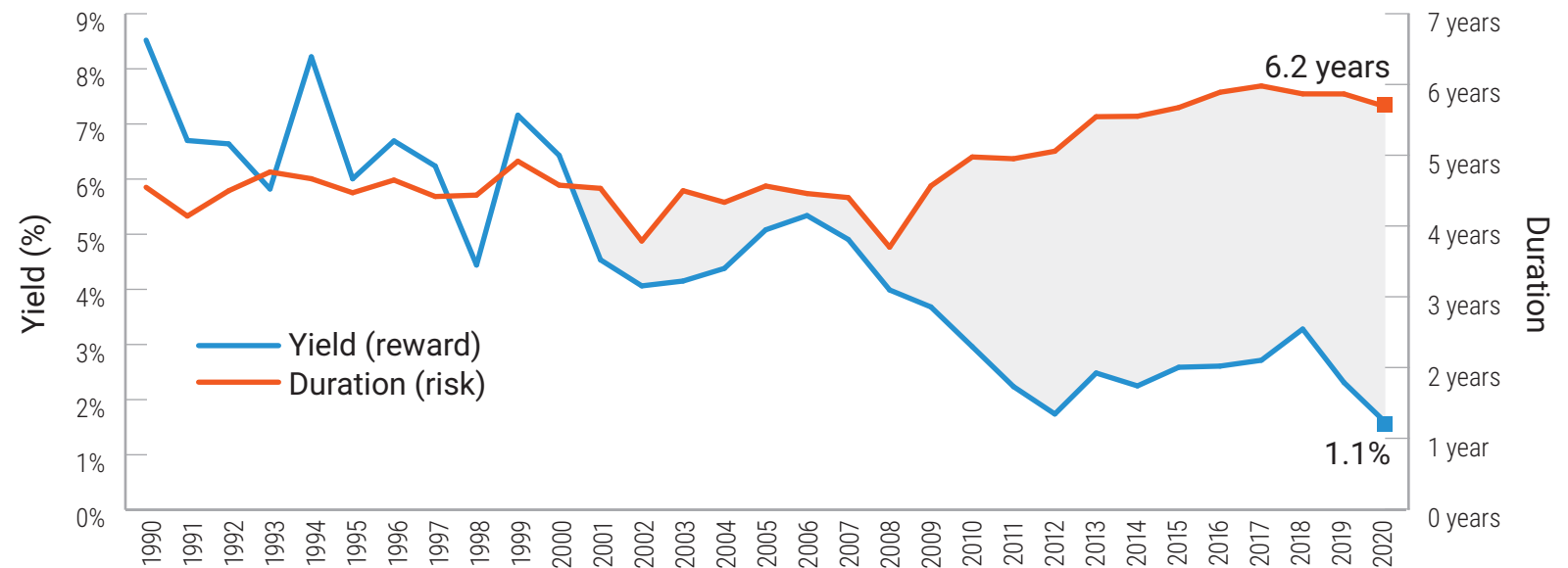
The higher a bond's duration, the more sensitive its price is to a change in interest rates.

Today's combination of low rates and high price sensitivity means even a small increase in rates can result in capital losses.

Low rates

High price sensitivity

Bloomberg Barclays U.S. Aggregate Bond Index characteristics



Source: Bloomberg, year-end 12/31/1990 – 4/30/20.

Date	Yield	Duration	How much would interest rates need to rise to completely offset the yield of the Agg?*
12/31/2020	1.1%	6.2 years	18 bps
12/31/2009	3.7%	4.6 years	80 bps
12/31/1999	7.2%	4.9 years	147 bps
12/31/1989	9.1%	4.5 years	200 bps

Source: Bloomberg, JPMorgan Asset Mgmt., annual figures represent the year's average.

*Yield increase for a 0% return on the Bloomberg Barclays U.S. Aggregate Bond Index uses the rule of thumb defining duration as the % point decrease in bond prices resulting from a 1% point increase in bond yields.

Stretching for yield – is it worth it?

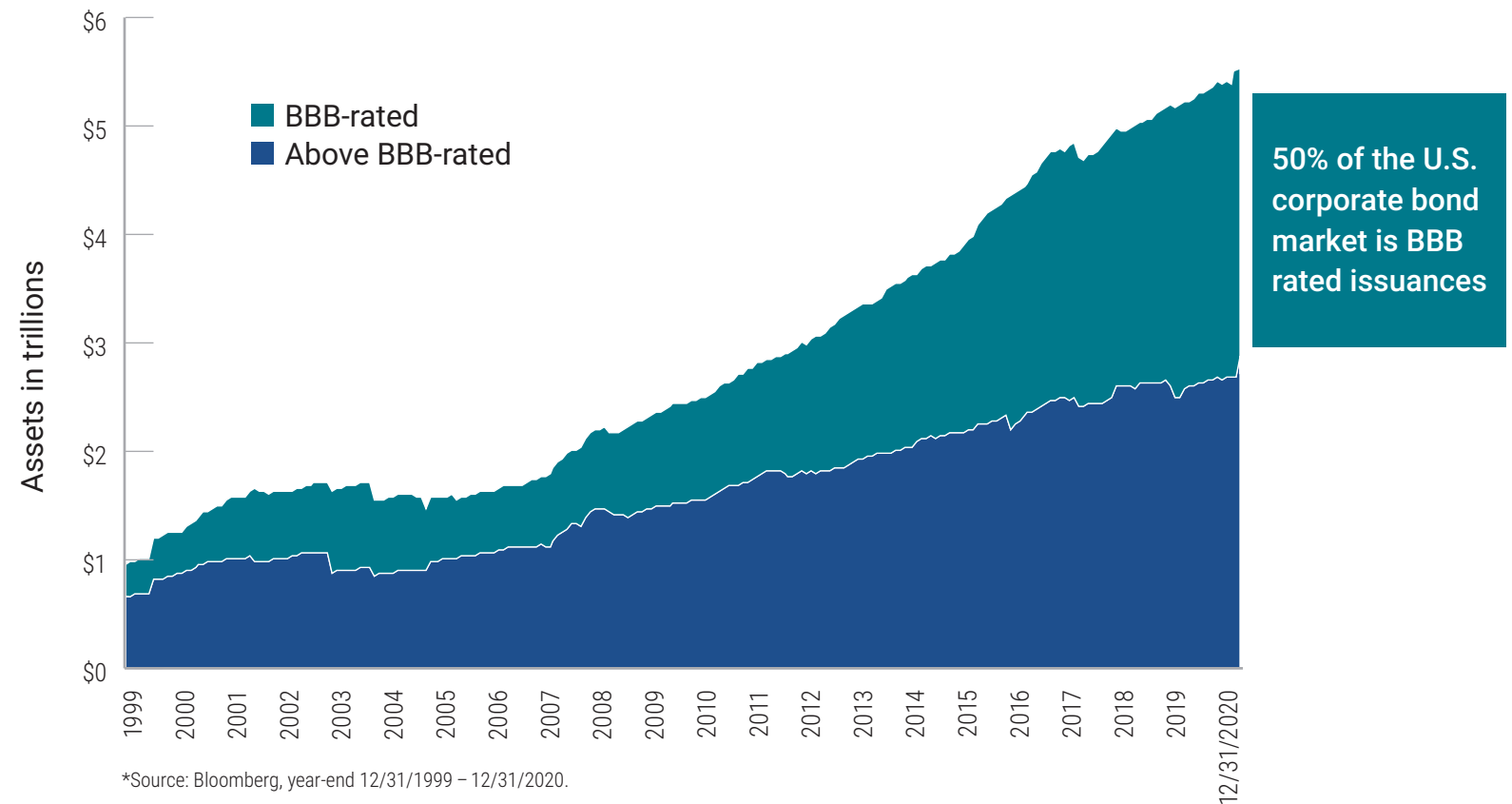
In search of higher yields, investors may turn to corporate bonds. When nearly 50% of the corporate bond market is BBB-rated debt, the lowest tier of investment grade ratings,* such a stretch for yield brings more risk than it once did. This is especially risky during a recession when it's more likely that companies will default or be downgraded, resulting in increased difficulty to attain yield.

When a bond's credit rating is downgraded, its price tends to drop in value. Often, just the anticipation of a downgrade can have this effect.

Standard & Poor's uses a scale rating from D to AAA. BBB is the ninth-highest rating out of 21. A bond must be rated BBB or higher to be considered investment grade. When a bond is downgraded from a BBB rating, it is considered a junk bond – typically rated "BB" or lower by Standard & Poor's.

Source: "S&P Global Ratings Definitions," 9/18/2019. https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourcelid/504352

Bloomberg Barclays U.S. Corporate Bond Index quality breakdown



What can we expect from future bond returns?

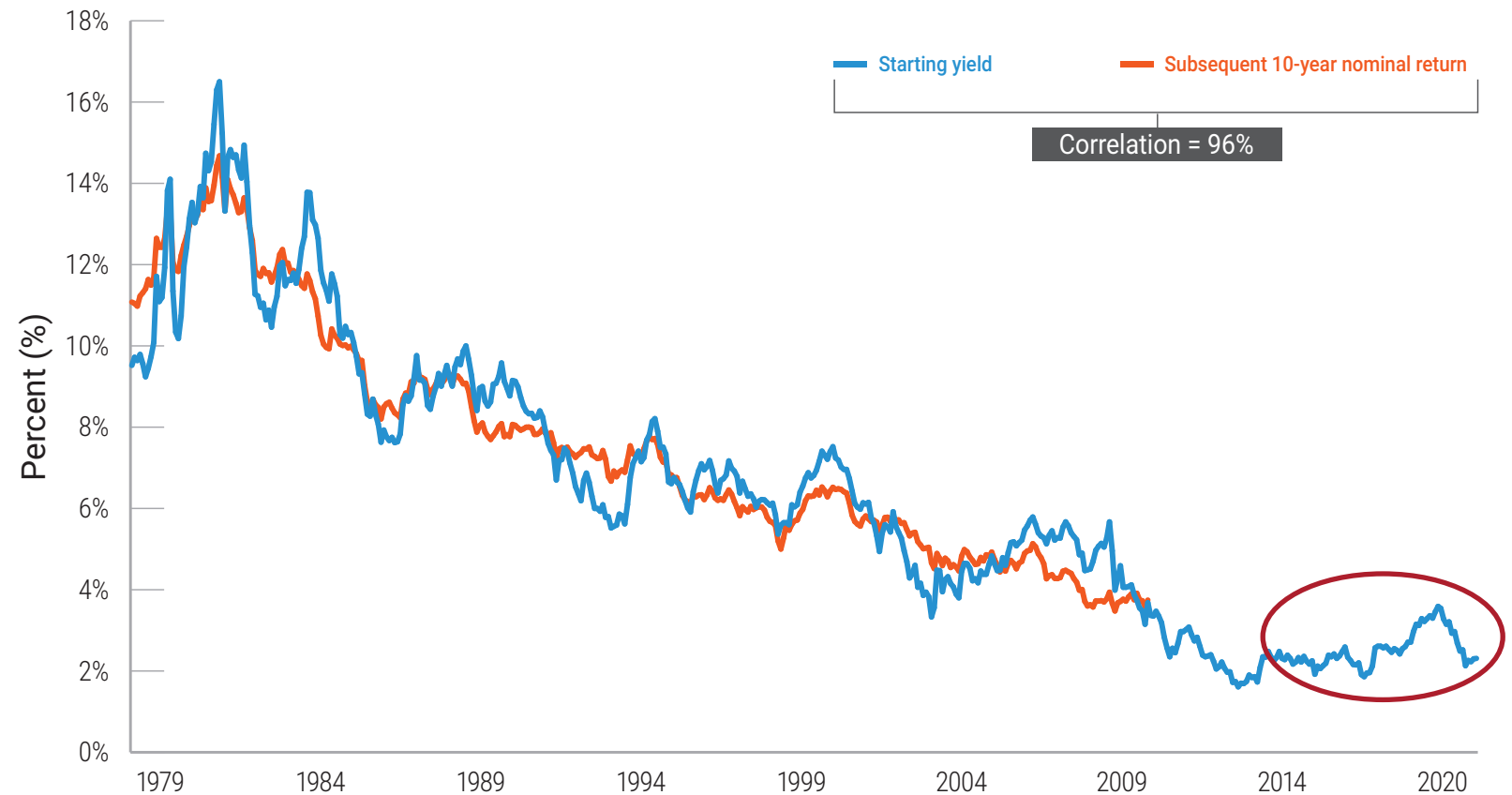
In addition to the shrinking yield cushion, rising interest rate risk and increasing credit risk, consider the low expected returns from fixed income. Over the past 30 years bond returns averaged approximately 6%. But it's unlikely fixed income will generate such returns in the coming years.

Nobody can say for sure what the market will do, but we do know that there is a strong correlation between starting bond yield and subsequent bond returns. If the correlation continues, given current yield, investors could **expect returns of 1% – 3% over the next decade.**

1.12%

**Current yield
(as of 12/31/2020)**

Bloomberg Barclays U.S. Aggregate Bond Index starting yield and subsequent returns



Source: Research affiliates based on data from Bloomberg and FactSet as of Dec. 31, 2020. Proxy: Bloomberg Barclays U.S. Aggregate Bond Index. **Past performance is not a guarantee or a reliable indicator of future results.**

Bringing protection and growth into balance

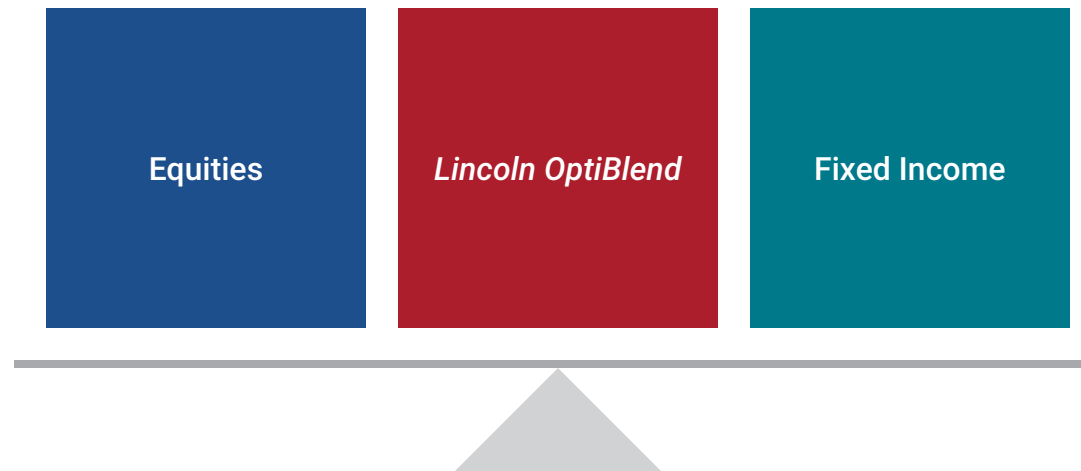
With bonds unlikely to generate meaningful returns, how do you position a portfolio for growth, while continuing to provide downside protection?

Clients nearing retirement may be more cautious about market risk and interested in a strategy designed to provide:

- **100% protection** to help guard against downturns
- **Upside potential** with growth tied to market indices
- **No cost**
- **Confidence** that you're working with a consistent and dependable provider

With *Lincoln OptiBlend* fixed indexed annuity as part of a portfolio, you may help your clients bring protection and growth into balance.

Portfolio with Lincoln OptiBlend[®] fixed indexed annuity



Indexed accounts are tied to market performance, but they are not an actual investment in the stock market. You cannot invest directly in an index.



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- **Fitch: A+**
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- **Moody's: A1**
(5th highest of 21)
- **Standard & Poor's: AA-**
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