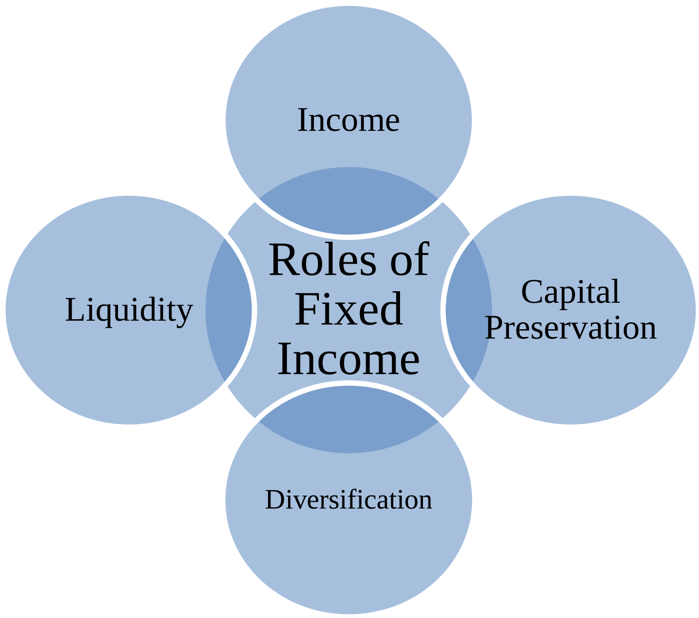
SilverOak
WEALTH MANAGEMENT LLC

August 2024

Roles of Bonds in a Portfolio

Amid ongoing volatility in the fixed income market and attractive yields on cash instruments, some may question the continued relevance of bonds. Recent price declines, driven by rising inflation and interest rates over the past few years, have heightened these concerns. However, it is crucial to recognize that fixed income investments (i.e., bonds) remain a fundamental pillar of diversified portfolios. In addition to providing income, bonds are an effective risk management tool helping cushion investors from market turbulence and achieve their financial objectives. This paper will explore how bonds function in a portfolio, analyze their recent performance, and provide an outlook on future expected returns.

Primary roles of traditional fixed income:



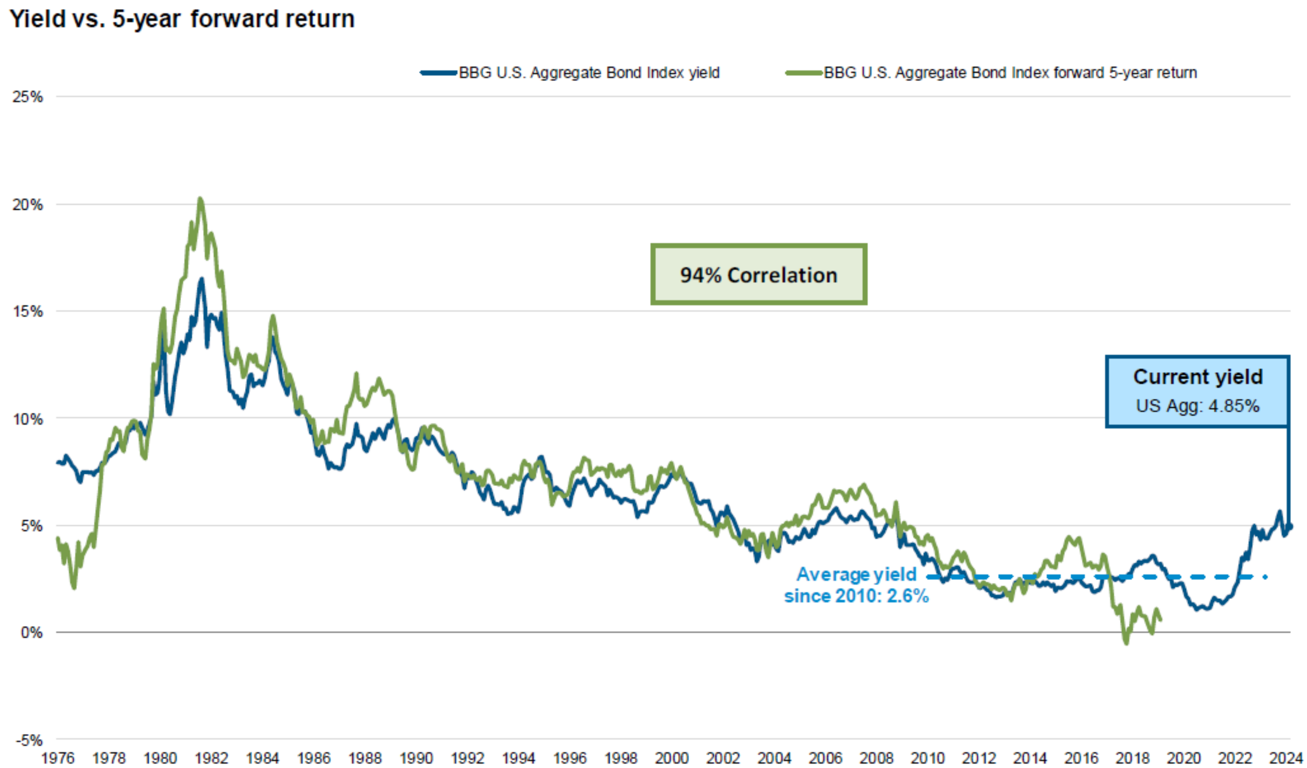
Income	Capital Preservation	Diversification	Liquidity
• Predictable income stream that can be spent or reinvested	• While price can fluctuate, fixed income is less volatile than other asset classes and over the long-term maintains asset value	• Bonds offer downside protection during equity market drawdowns. Thus, bonds can be additive to a portfolio	• Bonds can be a source of liquidity in a portfolio as price is more stable

Fixed Income Risk and Return Characteristics

Fixed income investments have historically returned 4% - 6% annually, with a standard deviation of approximately 4% - 6%. However, these are long-term averages, and the actual return and volatility can vary over different periods. Compared to stocks, bonds tend to underperform over the long-term. Nonetheless, bonds serve a distinct purpose in an investment portfolio by offering stability and income.

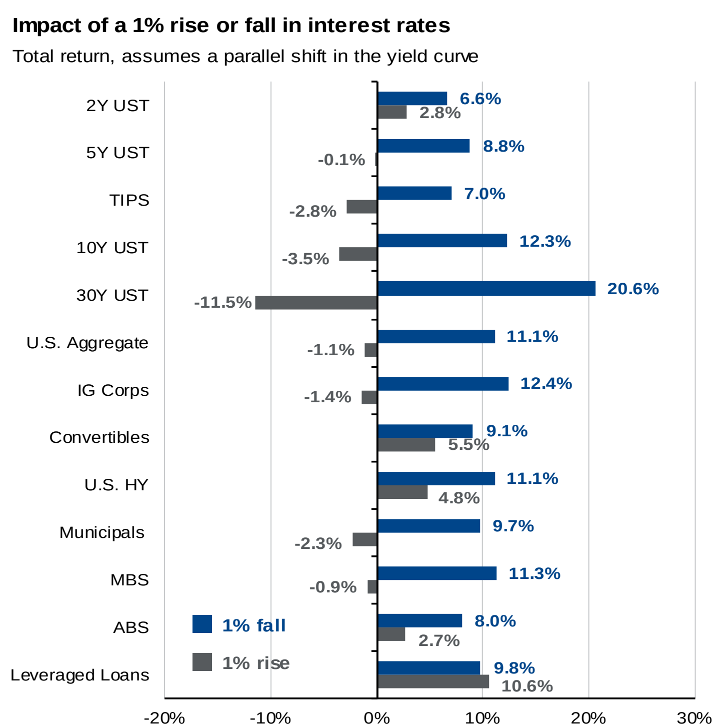
The primary sources of bond returns include:

- **Yield**: Bond returns are closely tied to the current yield of the investment. Typically, 5-10 year forward returns strongly correlate with the starting yield, as shown in the chart below. Yields are currently relatively attractive compared to historical levels.

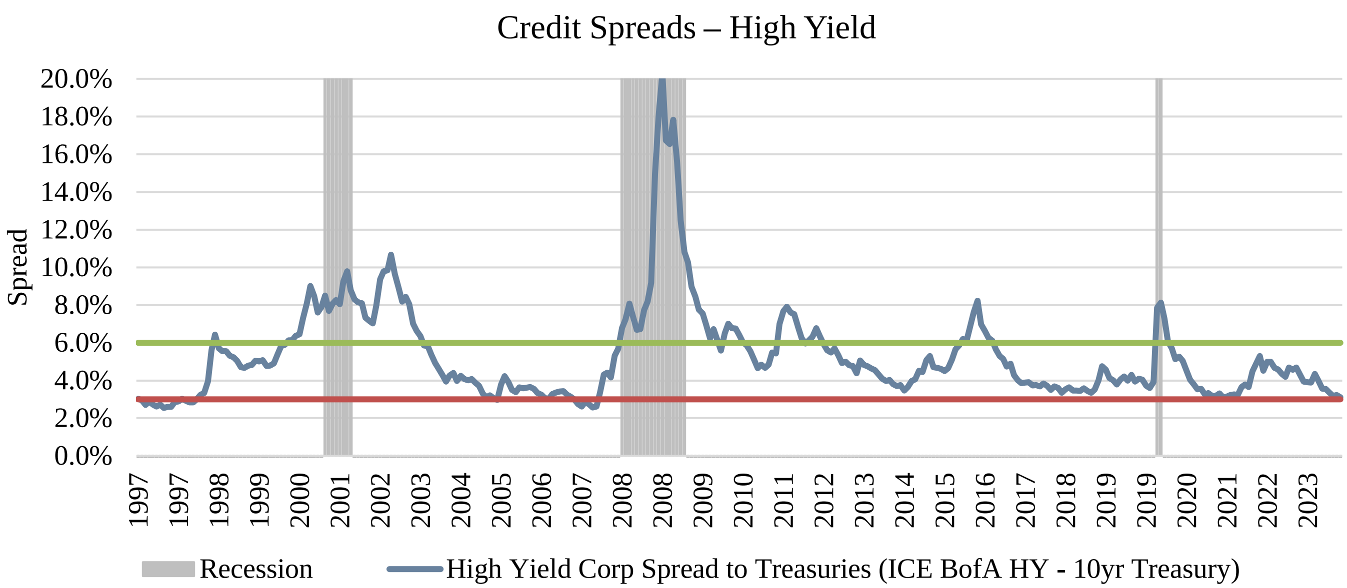


As of 31 March 2024. Source: Bloomberg, PIMCO

- **Interest Rate Changes:** Duration measures a bond's sensitivity to interest rate changes, which can significantly impact fixed income returns. Generally, for every 1% increase or decrease in interest rates, a bond's price moves in the opposite direction by approximately 1% for every year of its duration. For example, if a bond has a duration of six years and interest rates decrease by 1%, the bond's price is expected to rise by around 6%. Conversely, if rates increase, the bond's price declines. The chart to the right shows potential returns for different fixed income indices if rates rise or decline by one percent. Source: JPMorgan, as of 6/30/24.



- **Credit Spread Changes**: Credit spreads represent the difference between risk-free assets and bonds with credit or default risk. These spreads act as a risk premium that investors demand for taking on additional risk. Spreads tend to decrease during economic expansions when investor confidence rises and perceived default risk diminishes. Conversely, spreads will widen during periods of economic turmoil. The chart below shows credit spread changes in high yield bonds, as of 6/1/24.



- **Inflation Changes:** Inflation can impact fixed income returns by affecting real returns, but it can also influence potential interest rate changes. Higher inflation may lead to higher interest rates, which can be detrimental to fixed income returns.
- **Currency**: For international fixed income investments, foreign exchange rate fluctuations can affect returns when bonds are denominated in different currencies. Currency risk adds an additional layer of potential return and risk.
- **Capital appreciation**: Bonds can appreciate or depreciate due to changes in interest rates. When rates decline, bond prices rise, potentially leading to capital appreciation in addition to the regular interest income.

Recent Performance

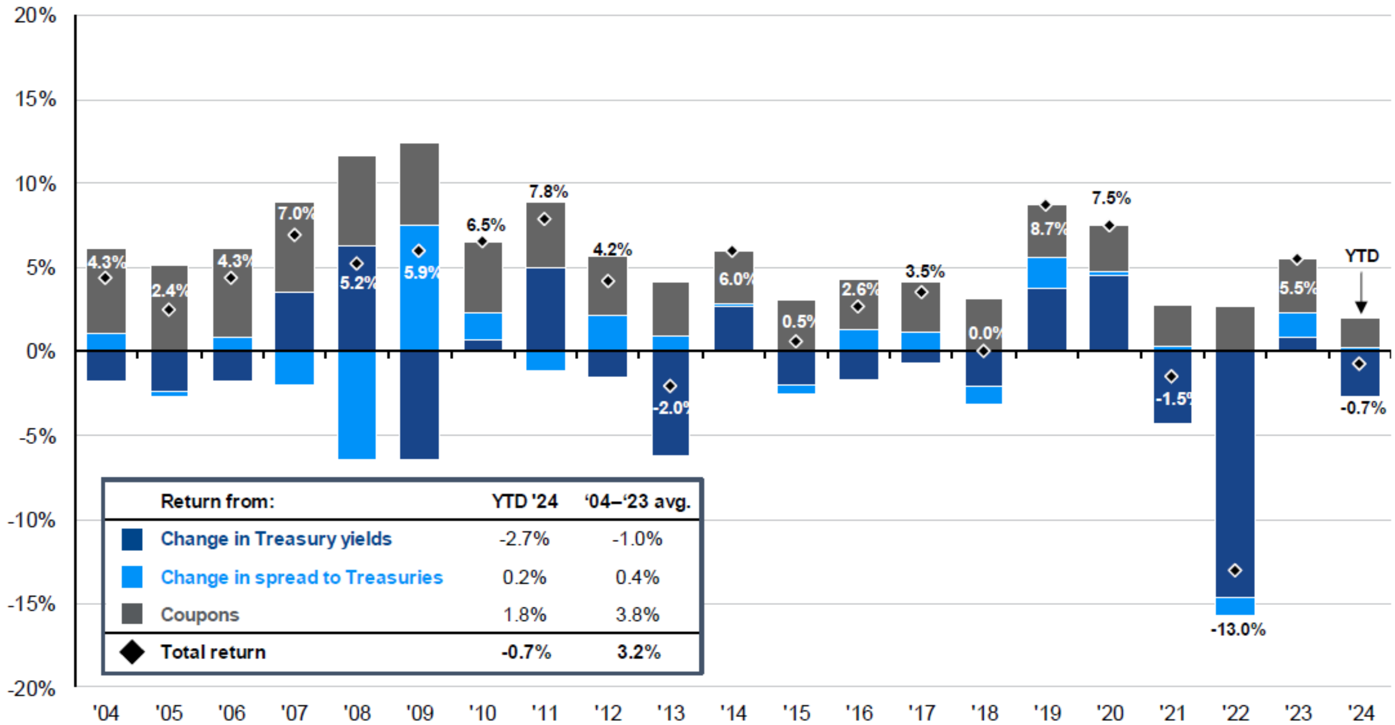
The chart below provides insights into recent bond performance. It displays the annual total returns of the Bloomberg U.S. Agg Bond Index since 2004 and breaks down these returns by coupons, credit spreads, and interest rate changes.

Historically, most fixed income returns over the long term come from the coupon. From 2004 to 2023, the average total return was 3.2%, with 3.8% coming from the coupon (shown in grey). During this period, credit spreads contracted and contributed an additional 0.4% to returns (shown in light blue). Spreads can widen and detract from returns in certain years, such as in 2008. The dark blue section of the chart shows the return attributed to interest rate changes. As seen below, returns are impacted positively when rates fall, and visa-versa.

Bond returns have been weak over the past three years due to rising interest rates. At the beginning of 2021, the yield on the Bloomberg U.S. Agg Bond Index was around 2%. During 2021, the interest rate on the 10-Year Treasury rose from 0.93% to 1.52%, resulting in a -1.52% return for the Index as the coupon could not offset the price loss. In 2022, rates increased more than expected due to rising inflation, leading to significantly negative returns.

Bloomberg U.S. Aggregate annual total return

Total return broken into change in Treasury yields, change in bond spreads over Treasuries and coupon

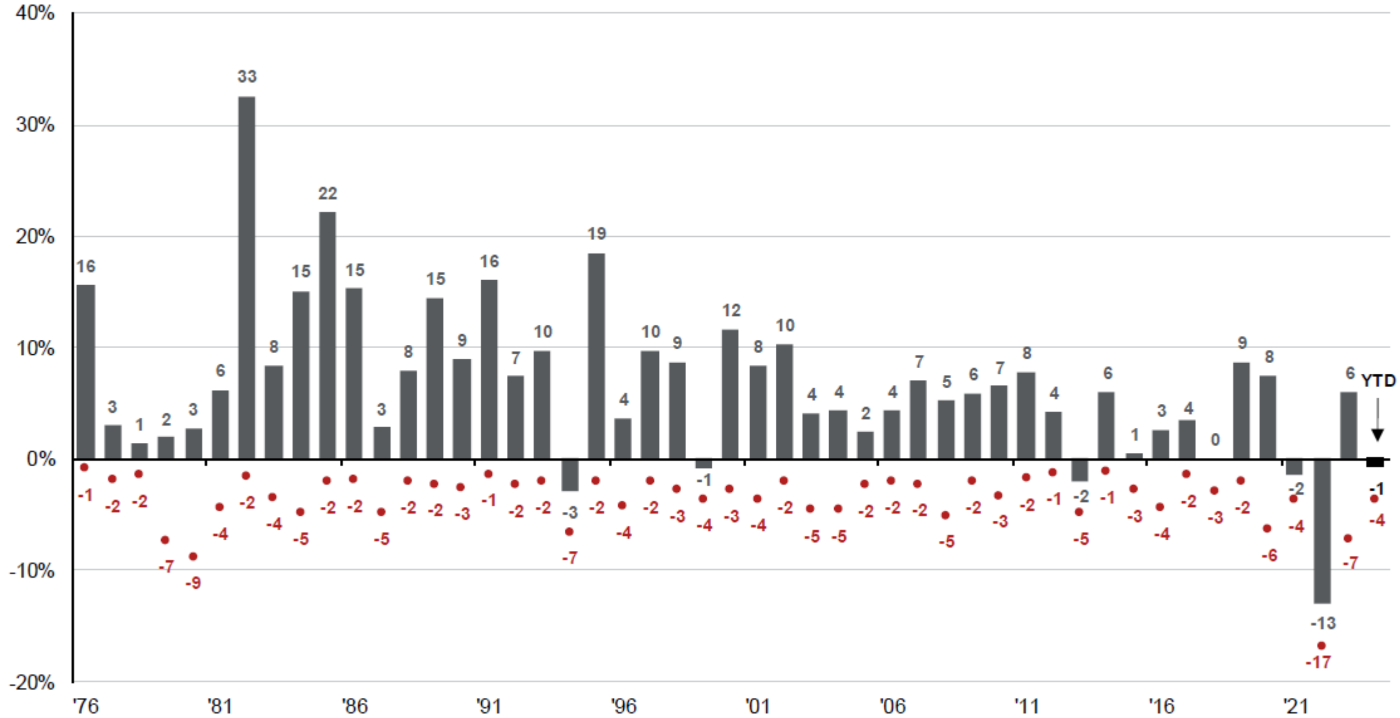


Source: Bloomberg, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30, 2024.

As is evident from the chart above, 2022 bond returns were a clear outlier compared to the past 50 years of performance. Interest rates typically climb over a multi-year period, but in 2022, rates increased sharply within a single year. Compounding the issue, equities were also down in 2022, a scenario in which bonds have historically performed well.

Bloomberg U.S. Aggregate intra-year declines vs. calendar year returns

Despite average intra-year drops of 3.5%, annual returns were positive in 43 of 48 years



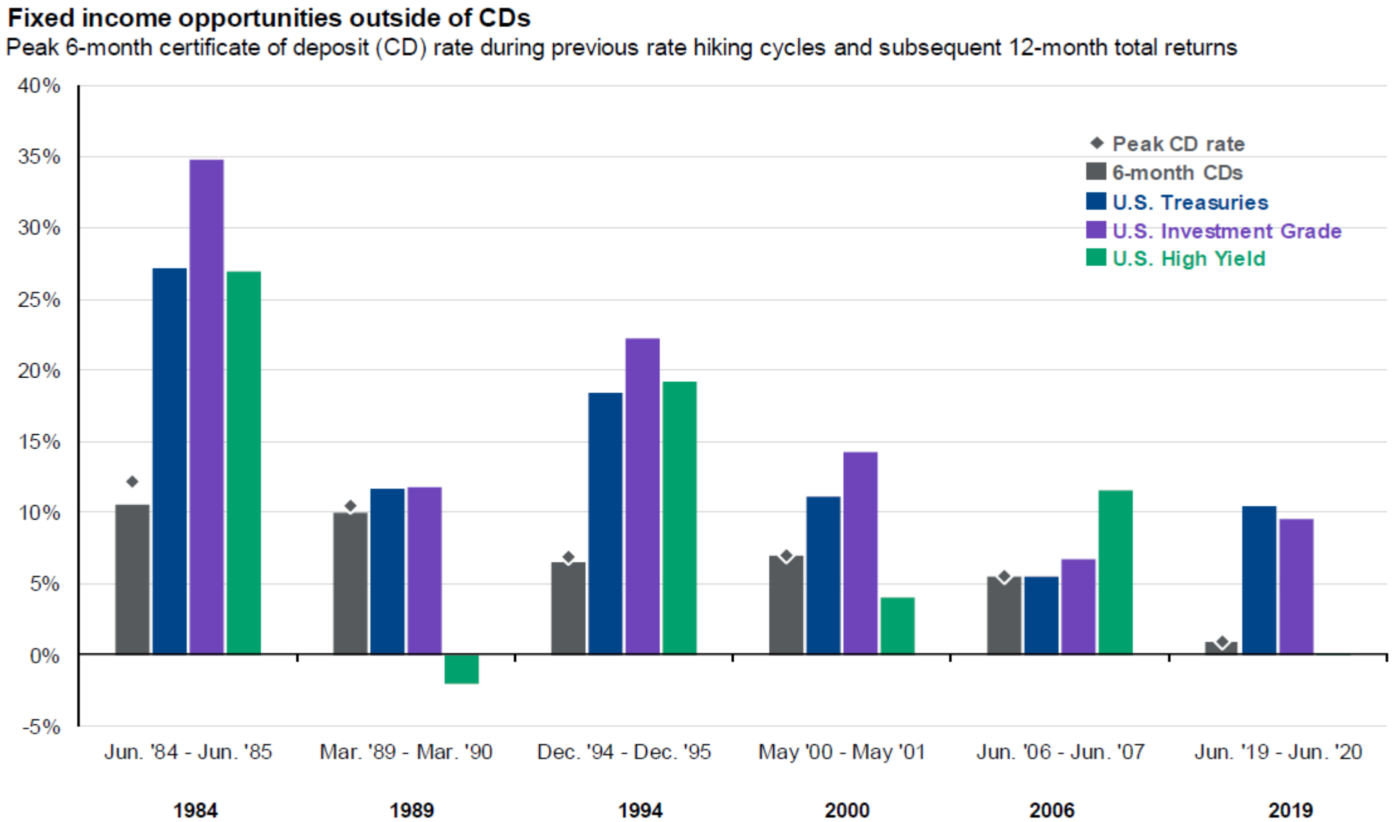
Source: Bloomberg, FactSet, J.P. Morgan Asset Management.
Returns are based on total return. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1976 to 2023, over which time period the average annual return was 6.6%. Returns from 1976 to 1989 are calculated on a monthly basis; daily data are used afterward.
Guide to the Markets – U.S. Data are as of June 30, 2024.

J.P.Morgan

Today's Environment & Future Outlook

The bond market has been more volatile recently as the market has tried to interpret the direction of the economy, inflation, and potential actions by the Federal Reserve. The Fed has indicated that policy rates have peaked and that rate cuts in 2024 are possible. Nevertheless, the Fed has not rushed to reduce rates and has raised GDP growth estimates and inflation projections for the year. Historically, in prior rate cycles, the Fed has held rates steady for several months before cutting. Thus, while rate cuts are not immediate, it is important to note that yields tend to decline before the Fed's first rate cut.

The yield curve remains inverted, with short-term yields higher than those further out on the curve. Despite this, there is reinvestment risk to consider. As shown in the chart below, bonds have tended to perform better than cash after interest rates peak. Bonds will benefit from price appreciation if rates fall, while cash and very short-term bonds would need to be reinvested at lower rates.



Source: Bloomberg, FactSet, Federal Reserve, JPMorgan, as of 6/30/24

Despite the current volatility, the risk-reward profile for fixed income remains favorable. Bonds provide income, potential for capital appreciation, and stability during an economic downturn. Going forward, the yield on bond funds is roughly 5%, and there is a strong correlation between starting yield and future returns over a 5+ year period. If rates fall, future returns could exceed the starting yield. Many bonds are priced at a discount to par, reducing downside risk as prices will eventually rise to par.

So, although bonds have recently exhibited higher levels of volatility, we believe they remain a vital component of many portfolios. The precise allocation to bonds and the exact type of bond fitting within each portfolio depend upon many factors, including the individual's risk profile, time horizon and liquidity needs. Furthermore, with interest rates likely to fall over the next year, cash and cash equivalents will likely no longer provide similar yields to the expected total return of bonds.

If you have any further questions regarding bonds and the role they play in a portfolio, please contact your SilverOak Advisor or Shannon King at sking@silveroakwealth.com or 952-896-5701.

Disclaimer:
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Investment decisions should be made based on an investor's specific circumstances taking into account items such as, risk tolerance, time horizon and goals and objectives. All investments have some level of risk associated with them and past performance is no guarantee of future success.