



"Insights and Innovation"

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The Decade of Bonds?

Does 2025 Begin a New Paradigm for Bonds?



Why Bonds?

- Growing consensus on weaker relative equity returns
 - Equity at 6.5% vs Bonds at 4.8%
- Greater need for diversifying equity volatility
 - Especially downside!
- Greater need for liquidity
 - Withdrawals only come from traditional assets
- Increased reliance on seeking alpha



Overpaying for Stocks: *Recipe for Weak Returns*



Howard Marks: "In the last 27 years, when investors bought the S&P at P/E ratios in line with today's multiple of 22, they always earned ten-year returns between plus 2% and minus 2%"

Misunderstanding Bonds

- Their Nature
- How they are Priced



Bonds Along the CAPM Asset Spectrum

Less Diversification Benefit



Bonds are Factor-Driven

- Bonds are a homogenous asset class
 - Driven by only a few **structural** factors
 - Factors = **Decisions** in creating a bond portfolio
- Key bond **factors**:
 - Who issued the bond (i.e. bond sector)
 - Time to maturity and duration (i.e. price sensitivity)
 - Quality rating
- Price is related to yield factors:
 - Risk free rate (related to duration)
 - Spread (related to sector and quality)



How Bonds are Traded and Priced

- Bonds don't trade as stocks do
 - Traded **OTC** via human interaction and negotiation
 - Treasuries trade frequently other bonds < 15% of total
- Bond prices are uncertain
 - Most prices are typically **calculated**, not observed
 - Some bonds act as price **proxies** for similar bonds
 - Newly-issued bonds reprice the market



Misusing Bonds: Assets that get No Respect



- In Multi-Asset Portfolios
- In Active Management



Are Bonds for Diversification... or Growth?

- Bonds as low-return, low correlation assets (vs Equity and Alts)
- Asset allocators try to maximize bond returns by including Spread Product and High Yield

Decreasing Diversification





Diversification Focus: *Offset Equity Losses*

• 2008 (Great Financial Crisis)

• S&P 500 loses 37%

Focus on

Downside

Portfolio Risk

- 10-year TSY gains 22%
- Long TSY gains **42%**
- Aggregate bonds gain 5%
- High Yield loses 15%

• 2000-2002 (Tech Wreck)

- S&P 500 loses 37% total
- Long TSY gains **48%** total ←
- Agg bonds gain 33% total

High Quality
Long Duration

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Bonds in Multi-Asset Portfolio (1976-2022)





Bonds in Multi-Asset Portfolio (1976-2022)





More Efficient Diversification (1976-2022)

Efficiency: Equalizing contributions to return and risk

S&P-Agg	% Contribution to Return	% Contribution to Risk	Efficiency	S&P-TSY	% Contribution to Return	% Contribution to Risk	Efficiency
S&P 500	73%	86%	-13%	S&P 500	70%	75%	-6%
Agg	27%	14%	13%	TSY	30%	25%	6%

Using Treasuries cuts inefficiency by more than half

- Lower correlation from less credit risk
- Longer duration (exposure to Risk Free rate factor)



Bonds at their Best:

Cash Match Client's Financial Goals





Only Bonds Provide Certainty of Withdrawals

- Endowment or Foundation portfolio
- 5% spending target (based on 5-year average portfolio value)
- Payments should increase with inflation (2.5%)
- Desire certainty of payments (over 5-year horizon)

Solution:

Swap AGG bonds for cash flow matching portfolio (about 22% of portfolio)



CFM Portfolio Withdrawals



Withdrawals come from interest payments and maturities

- Risky assets (equity, alts) remain untouched
- Client can bear market volatility more easily
- Never invade risky assets in a down market



Active Bond Opportunities



Who Wins the Active Game: Stocks or Bonds?

"Most equity funds underperform their benchmarks..."

- In 2024, 84% of active bond ETFs beat their benchmarks
- In 2023 73% outperformed

Sources:

- Bianco Research
- Morningstar Direct
- Barron's Oct 9, 2024 ("Bond Funds Aren't Like Stock Funds. They Often Beat the Indexes.")





Sources of Active Bond Return

Long Term

Short Term

Execution

Structural Differences from Benchmark

• Higher spread exposure Out-of-Index sectors

Tactical shifts

- Sector Rotation
- Duration
- Yield curve exposure

• Other Factors and Trading

- Lower quality issuers (crossover trades)
- Convexity (CMBS)
- Roll (ABS)



Active Efficiency with Bonds 12-year Case Study of 60-40 Portfolio

Individual Performance



	Equity	Bonds
Active Return	0.83%	1.56%
Active Risk	2.88%	3.02%
Info Ratio	0.29	0.52

4 Stock Funds 4 Bond Funds

Within Portfolio



Active Bond Return is More Efficient

Mismeasuring Bonds:

- Misplaced Performance Attribution
- Missing in action: decision attribution



Worst Most Common Bond Attribution Problems

1.Not showing a monetary income return

2.Unnecessary complexity in the attribution model:

- Three duration effects Shift, Twist and Reshape
- Treating Convexity and Roll as primary factors

3.Getting too granular

4. Weighting errors

- Par and Coupon
- Yield Change



Active Decisions = Attribution Effects





Performance Effects

	Portfolio	Benchmark	Excess	
Income	0.39	0.42	-0.03	
Treasury	-1.09	-1.13	0.04	
Spread	1.71	1.52	0.19	
Selection	-0.05	0.00	-0.05	
Total	0.96	0.82	0.14	

Portfolio outperformed benchmark by 14 bps

- Key contributor was allocation via spread exposure
- Duration and yield curve exposure contributed slightly
- Income and selection were minor detractors







Yield Curve Exposure: Portfolio vs Benchmark





Duration Contribution: True Fixed Income Weighting





Performance Data by Sector

Benchmark	Coupon	Price	Duration	Treasury Change	Market Weight	Return
Govt	0.39	106.01	4.76	0.29	40%	0.67
Corp	0.52	97.13	6.08	0.38	18%	2.74
MBS	0.45	103.70	2.57	0.15	42%	0.13
Total	0.44	103.34	4.08	0.28	100%	0.82

Portfolio	Coupon	Price	Duration	Treasury Change	Market Weight	Return
Govt	0.27	104.58	3.78	0.23	35%	0.51
Corp	0.53	102.06	6.42	0.39	25%	2.84
MBS	0.45	103.54	2.71	0.15	40%	0.18
Total	0.41	103.53	4.01	0.27	100%	0.96

Benchmark sector spread changes are applied to portfolio



Sector Contributions to Excess Return

Performance Effects

	Portfolio	Benchmark	Excess
Income	0.39	0.42	-0.03
Treasury	-1.09	-1.13	0.04
Spread	1.71	1.52	0.19
Selection	-0.05	0.00	-0.05
Total	0.96	0.82	0.14

Sector-Level Alpha Contributions by Decision Factors

	Income	Treasury	Spread	Selection	Total
Govt	-0.04	0.20	-0.13	-0.08	-0.05
Corp	0.01	-0.14	0.28	0.02	0.16
MBS	0.00	-0.02	0.04	0.02	0.03
Total	-0.03	0.04	0.19	-0.05	0.14



Sub-Sector Analysis of Excess Return

Sector and Sub-Sector Attribtion

	Income	Treasury	Spread	Selection	Total
 Govt	-0.036	0.200	-0.130	-0.085	-0.050
Treasuries	-0.037	0.189	-0.123	-0.078	-0.048
Agencies	0.001	0.011	-0.007	-0.007	-0.001
	Income	Treasury	Spread	Selection	Total
 Corp	0.005	-0.140	0.277	0.019	0.161
Industrial	-0.001	-0.130	0.221	0.033	0.123
Utility	0.009	0.097	-0.126	-0.034	-0.055
Financial	-0.003	-0.107	0.183	0.021	0.093
	Income	Treasury	Spread	Selection	Total
MBS	-0.001	-0.023	0.039	0.018	0.033
Fixed Rate MBS	-0.002	-0.009	0.003	0.015	0.007
Hybrid ARMs	0.001	-0.014	0.036	0.003	0.026

Total	-0.03	0.04	0.19	-0.05	0.14	
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Breaking Out Yield Curve Return Contributions

	Income	Treasury	Snread	Selection	Total	Parallel	Non-Parallel
	Income	Treasury	Spicad	Selection		TSY	TSY
Govt	-0.04	0.20	-0.13	-0.08	-0.05	0.09	0.11
Corp	0.01	-0.14	0.28	0.02	0.16	-0.05	-0.09
MBS	0.00	-0.02	0.04	0.02	0.03	-0.02	0.00
Total	-0.03	0.04	0.19	-0.05	0.14	0.02	0.02
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Wonderful Bond Insights

- 1. Bonds are a critical asset class for multi-asset portfolios
 - Bonds are essential to managing volatility risk
 - Bonds preserve portfolio value during severe downside events
- 2. Bonds provide certainty of withdrawals to "pay the bills"
 - Strongest form of asset-liability management or "LDI"
 - Goals-based outcomes: liquidity and capital preservation
- 3. Bond may be THE key asset of the next decade
 - Strong risk-adjusted market return
 - Likely source of active return





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"I get by with a little help from my friends..."

