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BLOG POST

Are Treasuries Still a Hedge to Equities?

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Combining stocks and bonds to form balanced allocations for growth and income has been the cornerstone of portfolio construction for decades. For the most part, the approach has worked reasonably well. A broad, diversified allocation to equities, such as the S&P 500, combined with a diversified allocation to bonds, such as Treasuries and corporate debt, has generally provided an attractive real rate of return.

What has made the balanced portfolio attractive is that the return correlation between stocks and bonds has historically been low to negative. When equities valuations fell, bond prices tended to rise, and vice versa. The result was a smoother return stream that allowed for the compounding of long-term returns.

Today's environment poses a challenge, however. With elevated inflation and the prospect of materially higher interest rates, the return prospects for a core bond portfolio are diminished. Likewise, equity valuations could come under pressure if earnings don't offset the effects of higher inflation.

Moreover, today, real yields are generally negative given the current rate of inflation. It is little wonder that investors have looked beyond the traditional bond market for income opportunities, such as private real estate or structured credit.

Should investors abandon traditional bonds completely as an asset class? In other words, should investors make a blanket assumption that bonds, in any capacity, no longer serve a purpose in the portfolio construction process?

Our view is that bonds, particularly longer duration Treasuries, can provide a hedge (i.e., a negatively correlated source of return) to extreme equity volatility, despite the current headwinds in the bond market.

From a total return standpoint, or when you consider both income and changes in price, the volatility of long duration Treasuries can potentially be negatively correlated with the volatility of equities at market extremes.

The chart to the right illustrates the total return of the iShares 20+ Year Treasury Exchange Traded Fund (Ticker: TLT) going back to inception in 2002. The long-term price reveals a particular pattern. Historically, the price of TLT has spiked during periods of heightened equity volatility. The chart is illustrated in a logarithmic scale to show percentage changes over time.

Some of the most obvious moves for TLT came during the onset of the global financial crisis of 2008 and, more recently, during the outbreak of COVID in 2020. Likewise, there are spikes throughout the history of TLT that generally correspond in a negative way to declines in the overall equity market.

While it is true that the secular decline in interest rates over the history of TLT has driven the long-term trend higher – a trend that might be coming to an end – it is also true that risk off trades have had a meaningful impact on performance. Risk off trades, by definition, are unpredictable.

For example, consider the onset of COVID, which sent the benchmark 10-year Treasury yield to 0.25% in 2020. Only two years prior, the Fed was on a course to begin raising interest rates. The plunge in yields over this period had nothing to do with monetary policy or an inflation outlook. It represented a flight to perceived safety when the global economy began shutting down.

To assume that a position in long duration Treasures is guaranteed to deliver negative returns, given the inflation and interest rate outlook, is to also assume that we will go an extended period with no exogeneous, unpredictable events that roil the global markets. If history is any guide, these events would likely push Treasury yields lower.

There are, of course, other ways to hedge equity risk in a portfolio. For example, there are timing models that seek to move to cash when equity volatility rises. Successful timing can be difficult, however, particularly in a sideways market.

Investors can also purchase put options on a broad index such as the S&P 500 to provide measured protection to the downside on an existing equity allocation. However, the cost of purchasing this insurance can be costly over the long run.

In our portfolios, we include long dated Treasuries as one of multiple hedges to equity risk. We size our position based on volatility and correlation estimates to equities and make periodic rebalances as market conditions change.