Vanguard

December 2024

Portfolio perspectives

Each month, you'll receive the latest insights from our Portfolio Solutions experts to help you address evolving issues that may affect your clients' portfolios.

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The rate-cut cycle has begun; are long-term bonds the way to go?

The Federal Reserve's shift in monetary policy on September 18, 2024, marked a pivotal moment for fixed income markets. In anticipation of the change, the 10-year U.S. Treasury yield, which peaked at 4.7% on April 30, decreased more than 100 basis points through September 16—two days before the Fed meeting. Many advisors who were waiting for the beginning of the easing cycle to start implementing changes to their clients' portfolios are now tasked with choosing a solution that would work best under the new monetary policy regime.

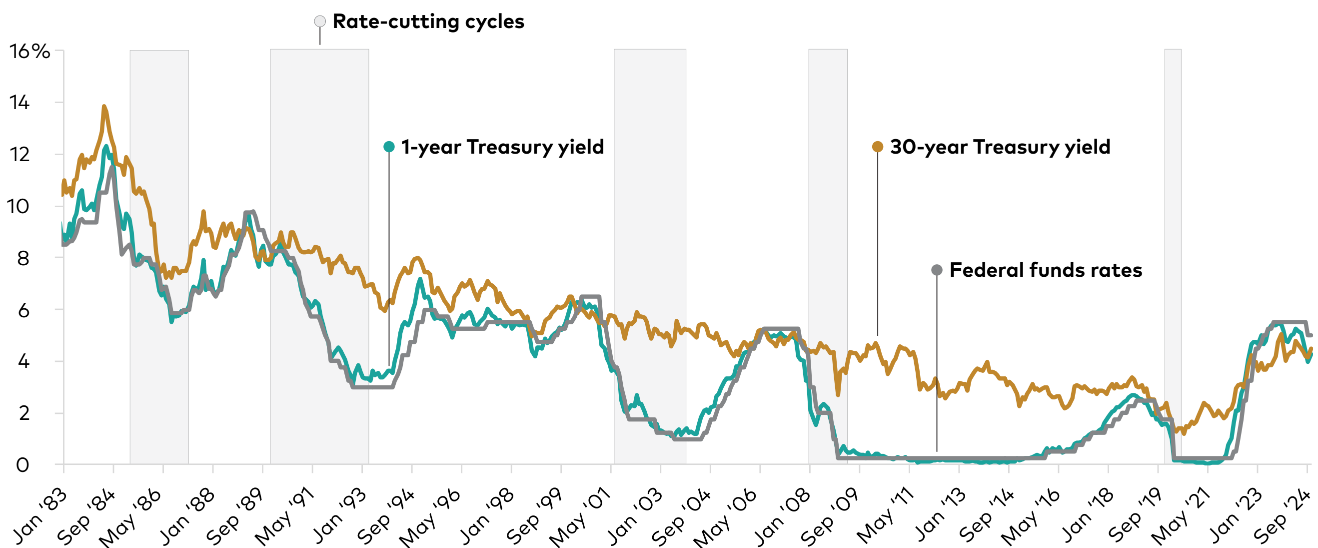
Most clients have warmed up to the idea of moving out of cash into longer-duration products. As a result, some advisors have been extending portfolio duration through purchasing long-term Treasury ETFs, attracted to the potential price appreciation associated with decreasing long-term interest rates. While long-term bonds may offer greater capital appreciation when interest rates decrease, such an approach might not always deliver the desired outcomes.

In some instances, Treasury yields across the curve decline, and their commensurate price appreciation occurs ahead of the Fed easing cycle. This is exactly what we observed in the months leading up to the September Fed meeting. This time, though, based on our conversations with advisors post-rate-cut, many were caught off guard by the more than 50-basis-point increase in the 10-year U.S. Treasury yield in the month following the first rate cut. This move underscored the importance of understanding the impact of rate cuts on long-term bonds and why clients should not equate Fed rate cuts with parallel shifts in the yield curve. For advisors, it is essential to always align investment strategies with your clients' long-term goals rather than betting on yield curve movements.

While historically, the short end of the yield curve is more directly correlated to the Fed's moves, the long end of the curve depends on a variety of factors and is usually a better reflection of growth and inflation expectations (see **Figure 1** below).

FIGURE 1: Short-term yields show higher correlation to the fed funds rate vs. long-term yields

Federal funds rate and yields over time



Past performance is no guarantee of future returns.

Sources: St. Louis FRED database, using Vanguard calculations, from October 31, 1982, through October 31, 2024.

Note: Shaded areas denote rate-cutting cycles.

Next steps for consideration: Understand duration trade-offs

Whereas long-term bonds can play an important role in a portfolio as a buffer during periods of equity market volatility, your clients should still weigh the inherent duration risk (susceptibility to interest rate changes). Help them understand that, while history has shown that, on average, bonds will outperform cash in a rate-cutting cycle, the further out on the curve your clients invest, the wider the dispersion of possible returns. Instead, it is important to focus on a strategic duration or matching the duration of your clients' bond holdings with the investment time horizon to minimize reinvestment and price risk.

Additionally, the inclusion of intermediate bonds in client portfolios might serve as a great option for clients who are cautious of the volatility associated with long-term bonds. Intermediate-term bonds are less sensitive to changes in rates and can still provide an attractive return potential in the current market environment.

If you're seeking optimal ways to extend duration, check out our **portfolio analytics tool** or speak with a specialist from our Portfolio Solutions team to review your portfolios to offer guidance on how to navigate this rate-cutting cycle.

Fixed income funds' contribution to a portfolio's return

Decomposing a portfolio's return can be done in many ways to explain the sources of contributors and detractors to performance. In financial media, we often hear about how much of the S&P 500 Index's returns the Magnificent 7 were responsible for, or their "contribution to return" based on both their individual performance and their weight in the index.

Alternatively, contribution to return is one way to evaluate how you size fixed income products within your portfolio. Consider the below model, a representation of the types of fixed income sleeves the Portfolio Analytics & Consulting team frequently sees advisors use (see **Figure 2**). Based on face value, the fixed income sleeve has diversified to many different Morningstar categories, with some categories being duplicated. Also, each fund delivered strong period returns as indicated by the "total return" column. Indeed, clients reviewing their statements would be pleased to see strong returns from their advisor's chosen fund lineup. However, the fund weights drop off on some of the lower-conviction holdings, namely the last three funds sized at 6% and 8%. While these funds performed well on their own, their weightings meant their contribution to the overall portfolio was comparatively insignificant (contribution to return is calculated by multiplying the weight by the total return).

FIGURE 2: Fixed income sleeves can be overly complex

A hypothetical fixed income portfolio

CATEGORY	AVERAGE WEIGHT (%)	TOTAL RETURN (%)	CONTRIBUTION TO RETURN (%)
	100.0	**9.9**	**9.9**
Intermediate core bond	15.0	9.4	1.9
Multisector bond	15.0	10.6	1.6
Nontraditional bond	15.0	9.9	1.5
Ultrashort bond	18.0	8.0	1.4
Intermediate core-plus bond	12.0	11.0	1.3
High-yield	6.0	15.6	0.9
Intermediate core-plus bond	8.0	7.9	0.6
High-yield	6.0	9.2	0.6

Past performance is no guarantee of future returns.

Source: FactSet, based on returns data from November 1, 2023, to October 31, 2024.

Fixed income returns are not nearly as large in magnitude as those of equities. Therefore, if a portfolio accumulates too many funds, the returns get spread out more thinly as less weighting goes to each fund. Also, the time required to study each of these funds and monitor their process and performance can take away from other tasks. While the intention may be to have a "well-diversified" portfolio by accumulating various funds, you can achieve the same level of diversification by building a fixed income sleeve where the main holding is a "true-to-label" core or a core-plus fund.

Next steps to consider: Streamline your fixed income portfolio

You can reduce complexity in your fixed income sleeve by monitoring the number of funds you own. Additionally, keep in mind the size of the overall fixed income sleeve in the asset allocation. The larger the equity allocation, the greater the contribution to risk from equities in your portfolio as opposed to fixed income. On the other hand, asset allocations where fixed income is a larger allocation will indeed allow an advisor to drive greater results through their fixed income fund selections. Don't forget about how your fixed income holdings contribute to risk. We see meaningful differences in contribution to risk among fixed income sleeves that are more credit-risk-heavy versus those that take larger allocations to sectors such as Treasuries or municipals. If you would like to see a contribution-to-return analysis on your portfolio, reach out to your Vanguard representative to request the Portfolio Analytics & Consulting team.

- **Vanguard Long-Term Bond ETF (BLV)**
- **Vanguard Long-Term Corporate Bond ETF (VCLT)**
- **Vanguard Long-Term Treasury ETF (VGLT)**

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