The Risk-Return Tradeoff In The Bond Market

Average Annualized Total Returns Of Major Bond Indices
(9/30/07-11/30/14)

View from the Observation Deck

1. One of the negative side effects from the financial crisis (systemic meltdown) in 2008-2009 was that some investors lost trust in “Wall Street,” in our opinion. For some, the system looked broke.

2. The risk-return tradeoff in investing implies that potential return rises with an increase in risk. In theory, investing in corporate bonds is inherently more risky, from a credit standpoint, than investing in government securities.

3. The Federal Reserve attacked the financial crisis primarily by lowering the federal funds target rate in the U.S. from 5.25% to 0.25% (9/18/07-Present) and by initiating three rounds of quantitative easing (11/25/08-10/31/14).

4. While opinions may vary as to how influential/responsible these efforts were in getting the capital markets functioning properly, the Fed’s involvement likely played a role in tempering the panic that permeated the markets, in our opinion.

5. At a base level, investors should be encouraged that the risk-return tradeoff in the capital markets largely functioned as one would have expected over the period (see chart). Those investors who assumed more risk generally achieved higher returns.

Source: Bloomberg. Past performance is no guarantee of future results.

This chart is for illustrative purposes only and not indicative of any actual investment. The illustration excludes the effects of taxes and brokerage commissions or other expenses incurred when investing. Investors cannot invest directly in an index. The BofA Merrill Lynch 22+ Year U.S. Municipal Securities Index tracks the performance of U.S. dollar denominated investment grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. The S&P/LSTA Leveraged Loan Index tracks the performance of a broad cross section of leveraged loans, including dollar-denominated loans to overseas issuers. The BofA Merrill Lynch U.S. Treasury Index tracks the performance of U.S. dollar denominated sovereign debt publicly issued by the U.S. government in its domestic market. The BofA Merrill Lynch U.S. High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. The BofA Merrill Lynch U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. The BofA Merrill Lynch Global Corporate Index tracks the performance of investment grade corporate debt publicly issued in the major domestic and Eurobond markets. The BofA Merrill Lynch All Convertibles All Qualities Index is a widely used index that measures the performance of U.S. dollar-denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance.