QUICK TAKES

Quick Clips: Yield Floors and Asset Allocation - When Is the Role of Bonds Impaired?

May 27, 2021

Over the past few years, yield levels have sparked questions around the role of bonds in asset allocation. Pre-pandemic bond yields were very low, and by the end of 2019, the average developed market yield was just 94 basis points. Investors worried that bonds faced asymmetric risks: yields had limited room for further declines and were bound by a floor, which limited any potential upside. However, prices could drop should yields rise.

When bond yields dropped even more during the pandemic, eventually reaching an average of 37 basis points by the end of 2020, investors became further concerned.

So far, in 2021, bond yields have been trending higher but remain near pre-pandemic lows, with a current average yield of 96 basis points. While the yield increases provide a little bit of breathing room, investors still question whether bonds will be able to generate an attractive return and provide diversification. At what point is the role of bonds in an asset allocation impaired?

The role of bonds in equity drawdowns and “stress scenarios" (0:28):

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We believe that the existence of a floor doesn’t doom bonds – only very restrictive yield floor assumptions matter. Our research has shown that if yields were to drop 100 basis points or more over the next year, a bond portfolio would not be impaired and traditional and risk balanced asset allocations would behave as if no yield floor existed.

The return-generating properties of bonds in risk-balanced portfolios (0:20):

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Given the yield increases in early 2021, we think a 100 basis point drop in yields is possible. Our goal is to help investors identify the point where their yield floor view materially impacts asset allocation in practice, or the point where bonds' return generation and diversification properties are impaired.

Evaluating your yield floor view and its impact on asset allocation (1:03):

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Source: AQR, Bloomberg. Yields above are the 10-year government bond yields for Australia, Germany, Canada, Japan, the United Kingdom, and the United States. The “floors” are purely for illustrative purposes and are meant to represent hypothetical “lower bounds” for yields. Hypothetical data has inherent limitations of which some are disclosed in the appendix. No representation is being made that any investment will achieve performance similar to those shown.

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