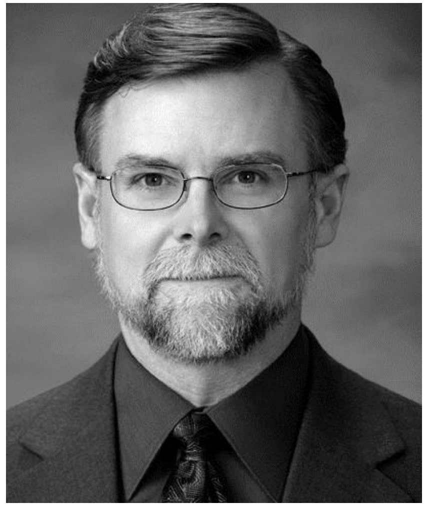
The problem with bonds

Rob Brown, PhD, CFA

Julex Capital Advisory Board Member, Website www.robbrownonline.com



40 Grove Street, Suite 140, Wellesley, MA 02482

Phone 781-489-5398

Email info@julexcapital.com

Web www.julexcapital.com

The problem with bonds

Are they an “investment” . . . or are they nothing more than an unfortunate “speculation”?

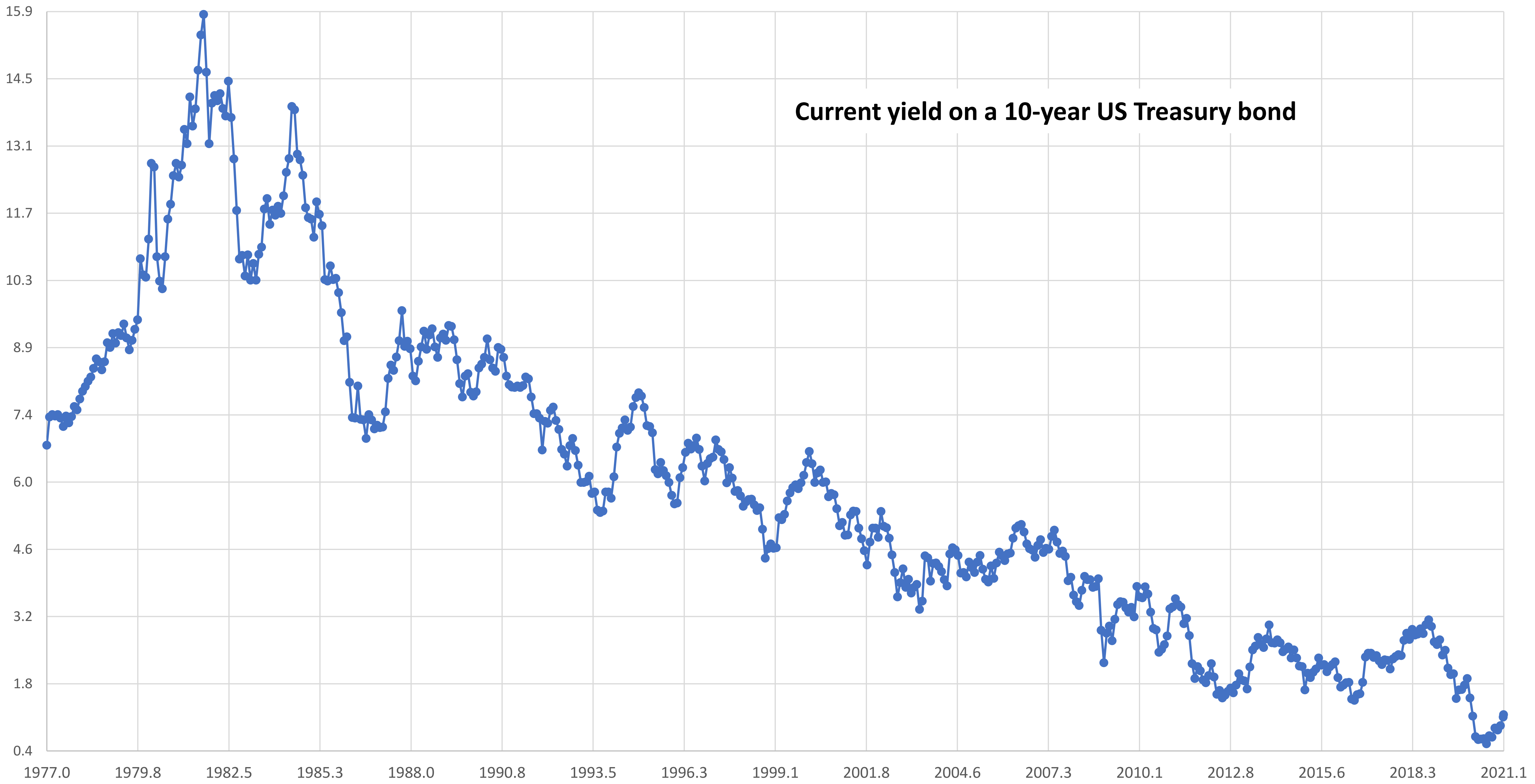
We just finished a 39-year bull market for bonds

No one remembers what bond bear markets are like

Now we will have a 39-year bond bear market

Are you playing the role of the ostrich?

Interest rates went from 16% to 0% over 39 years



The recent bond bull was preceded by an ugly bond bear

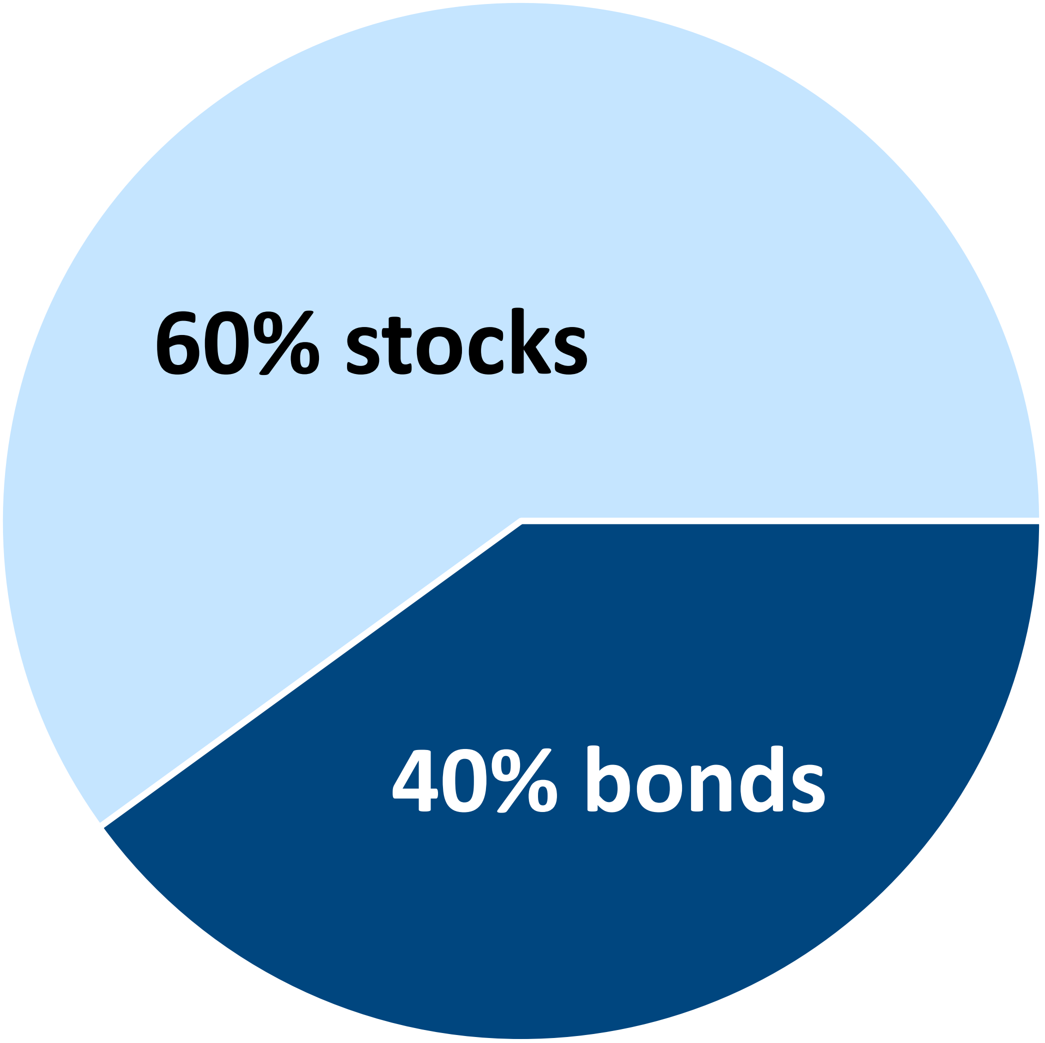
Are you in denial about bonds?

Why should we care?

Because bonds could (likely) be a disastrously poor “investment” going forward

. . . . and a potent source of client loss to another adviser

60/40 portfolio defined - sometimes called a "balanced portfolio"



Well diversified across the stocks of 500 prominent U.S. corporations

Well diversified across intermediate-term U.S. Treasury bonds and high-quality investment grade U.S. corporate bonds

60/40 portfolio has delivered consistent long-term success

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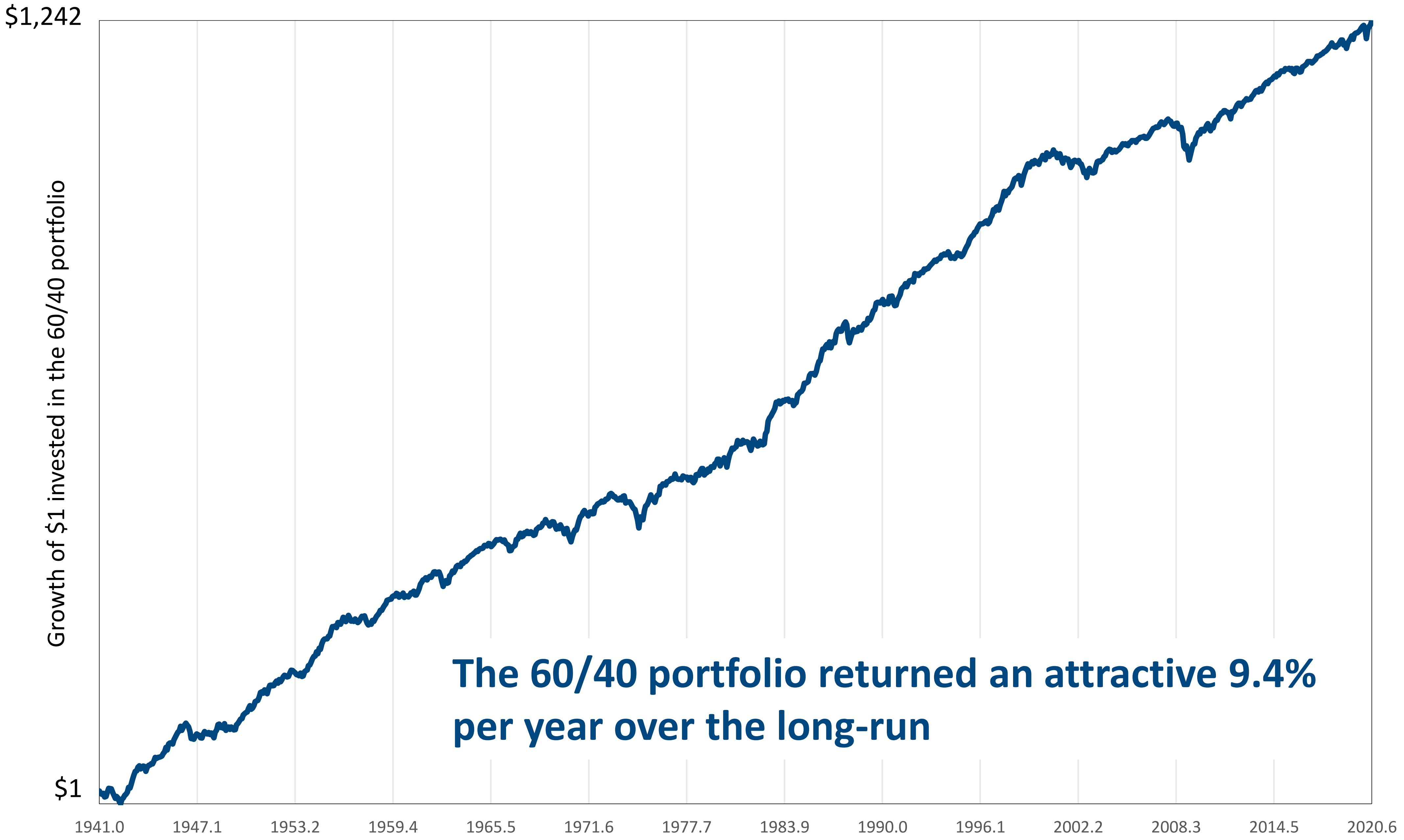
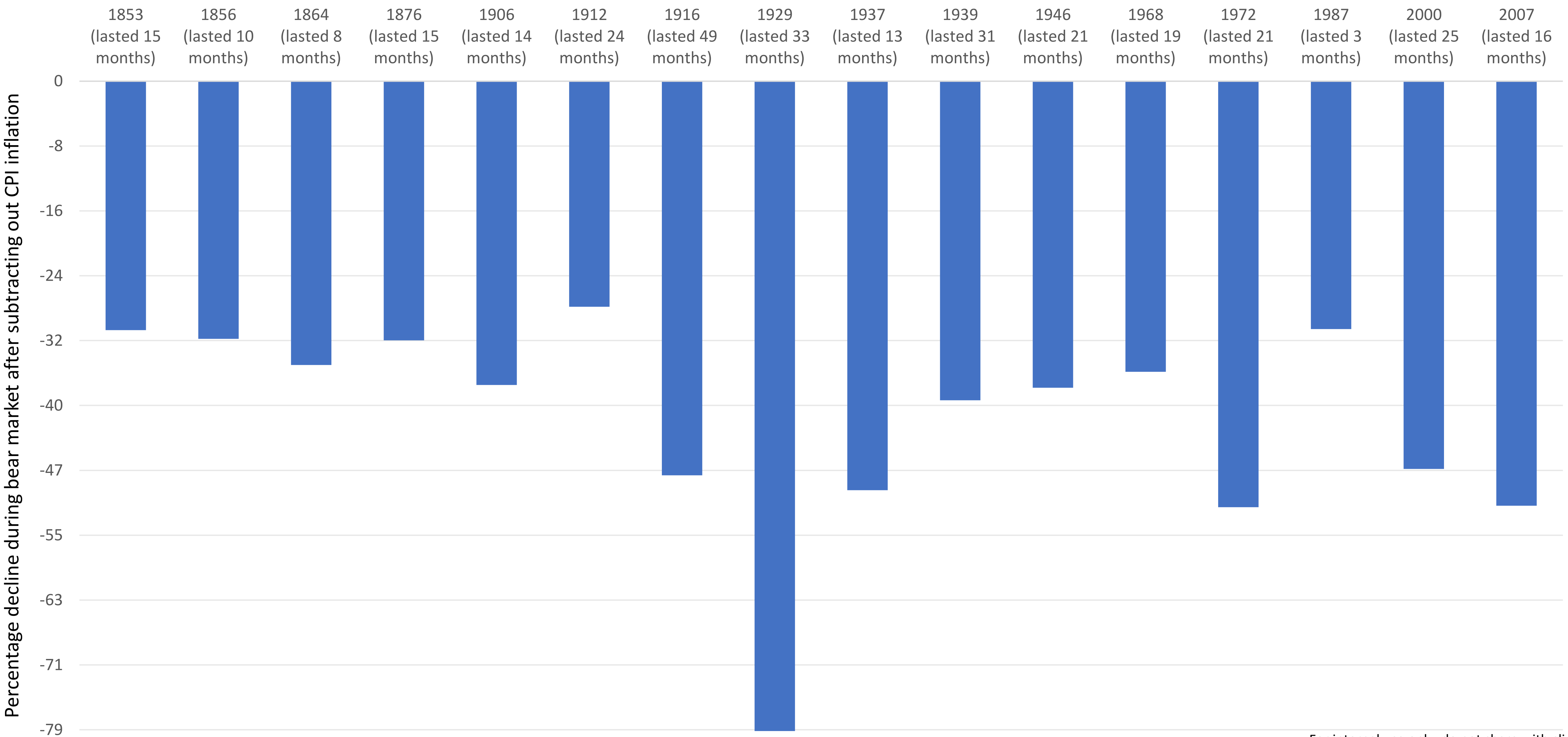


Bear markets have been both severe and long-lasting



See Disclosure # 2 on the last page

Bonds play a vital role within the 60/40 portfolio

Partially offset stock losses during bear market

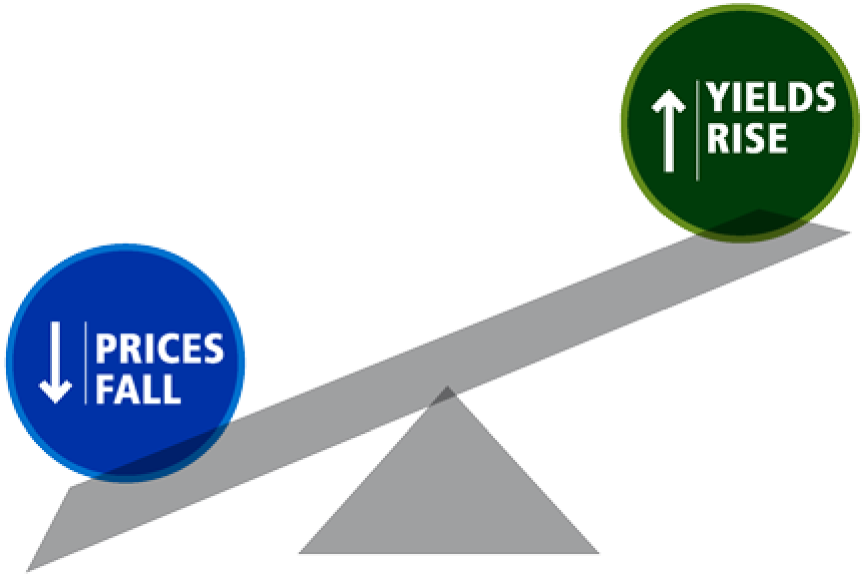
PRIMARY role of bonds in a larger portfolio

Current income

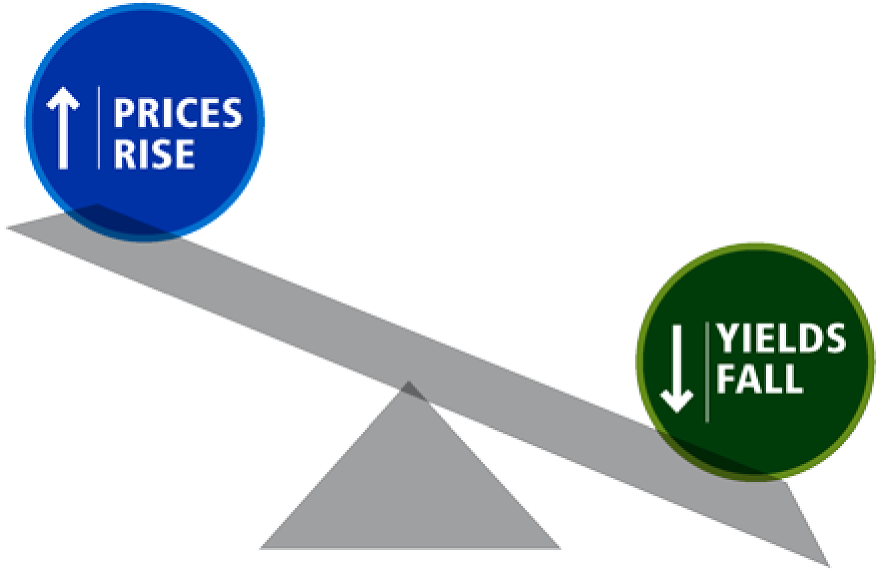
SECONDARY role of bonds in larger portfolio

Relationship between interest rates and bond prices

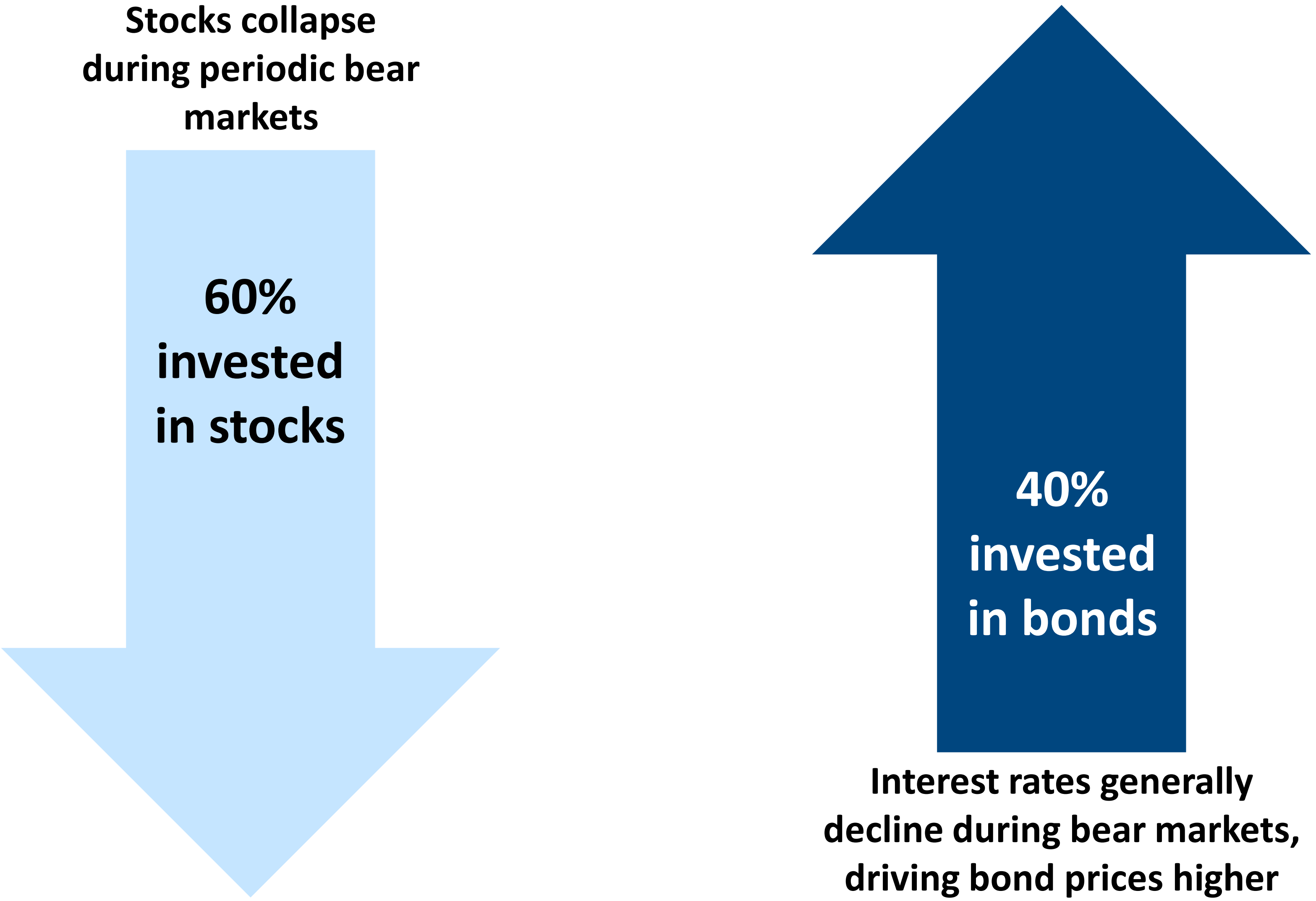
When interest rates rise



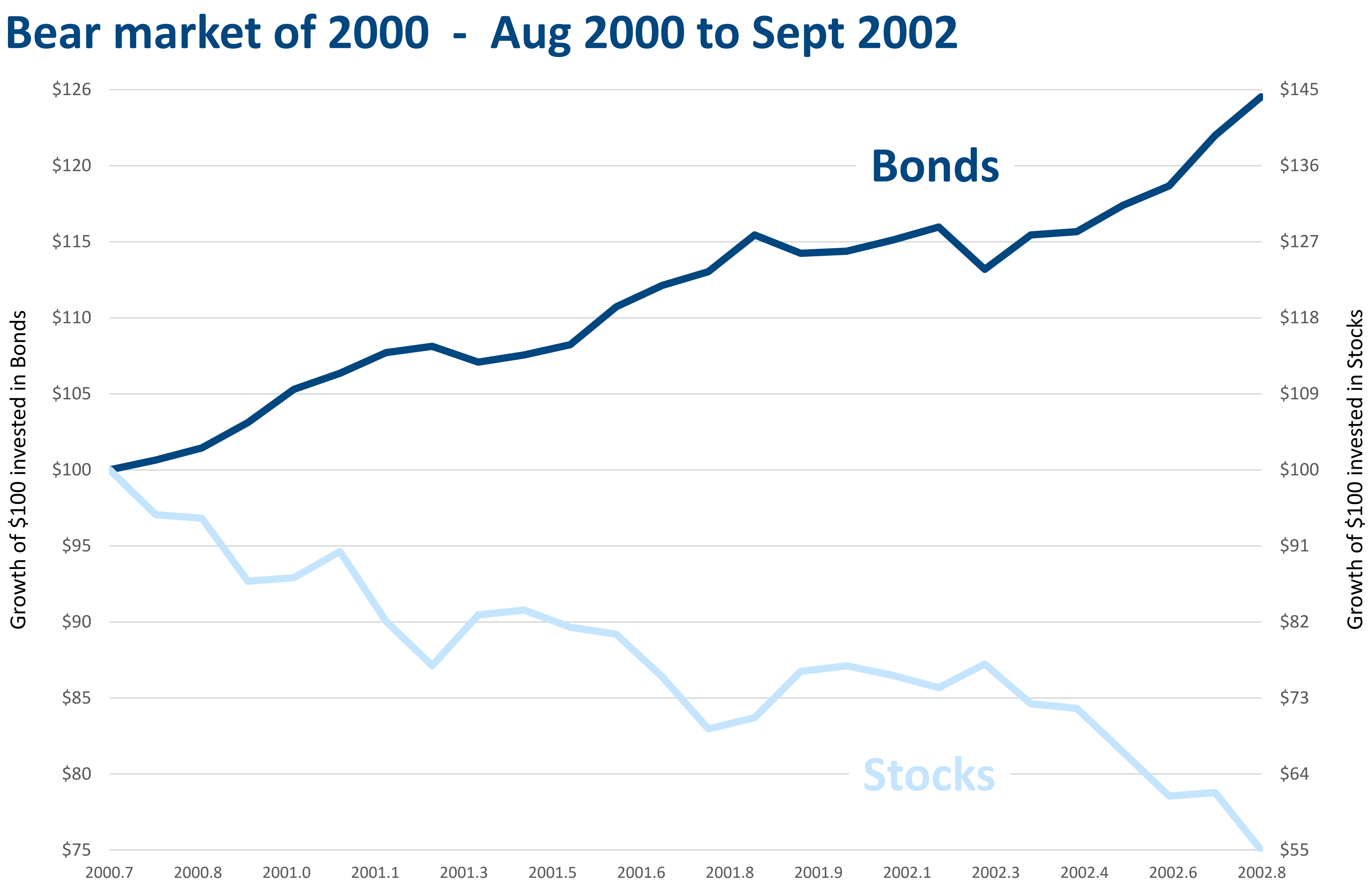
When interest rates fall



Why the 60/40 portfolio works so well



An example of past success - bonds play a vital role



A second example of past success - bonds play a vital role

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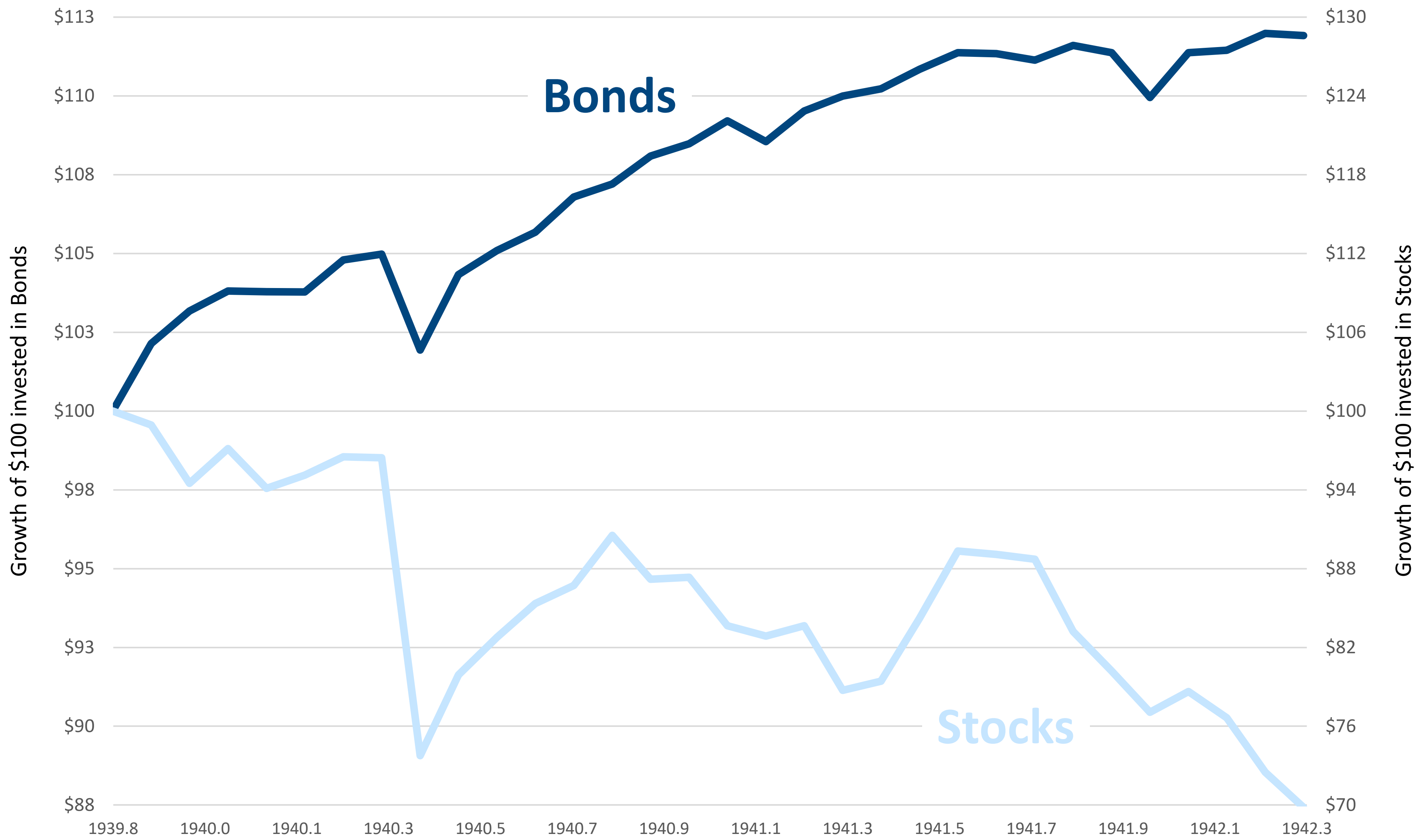
Bear market of 1939 - Sept 1939 to Apr 1942



What’s it like when interest rates rise?

Recall . . . you have to look back more than 40 years to understand

If interest rates rise, bonds can't play their necessary role

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Bond prices will rise or fall by the following amounts depending on the direction interest rates take

Change in interest rates (from current levels)	10-year U.S. Treasury bond	30-year U.S. Treasury bond
-25bps	**+2%**	**+6%**
+25bps	**-2%**	**-6%**
+50bps	**-5%**	**-12%**
+100bps	**-10%**	**-25%**
+200bps	**-19%**	**-49%**
+250bps	**-24%**	**-61%**

Based on where interest rates stood on August 19, 2020
Assumes an instantaneous change in the level of interest rates, i.e., overnight

See Disclosure # 6 on the last page

Great past performance provides NO basis for future success

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One of the very best bond funds

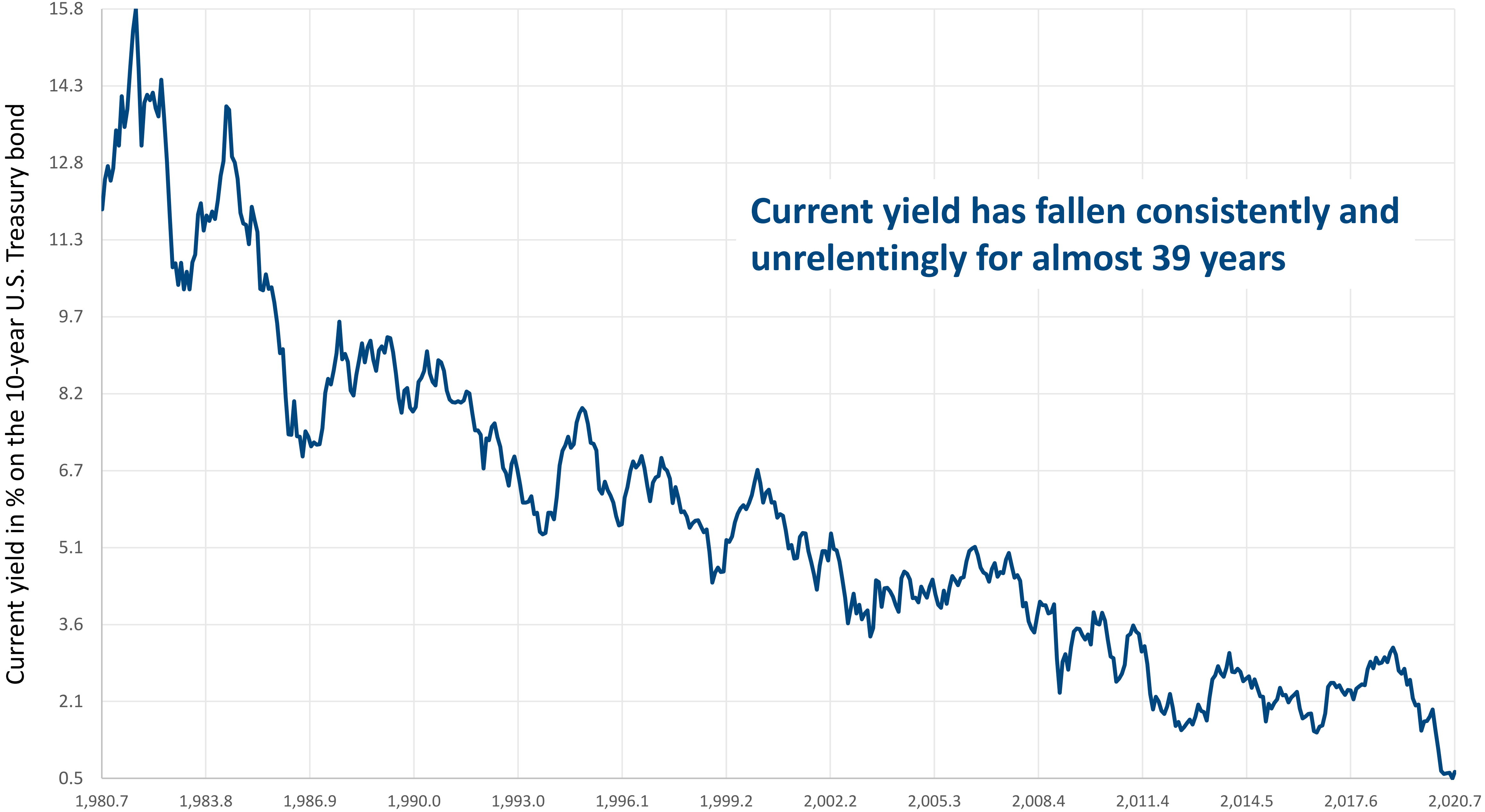
Vanguard Long-Term Investment Grade Bond Fund
(VWESX)

14.2%	year to date (through Aug 23rd)
22.5%	over last year
9.9%	per year, last 5 years
8.6%	per year, last 10 years
8.7%	per year, since inception (more than 37 years)

Returns other than year-to-date are as of July 31, 2020

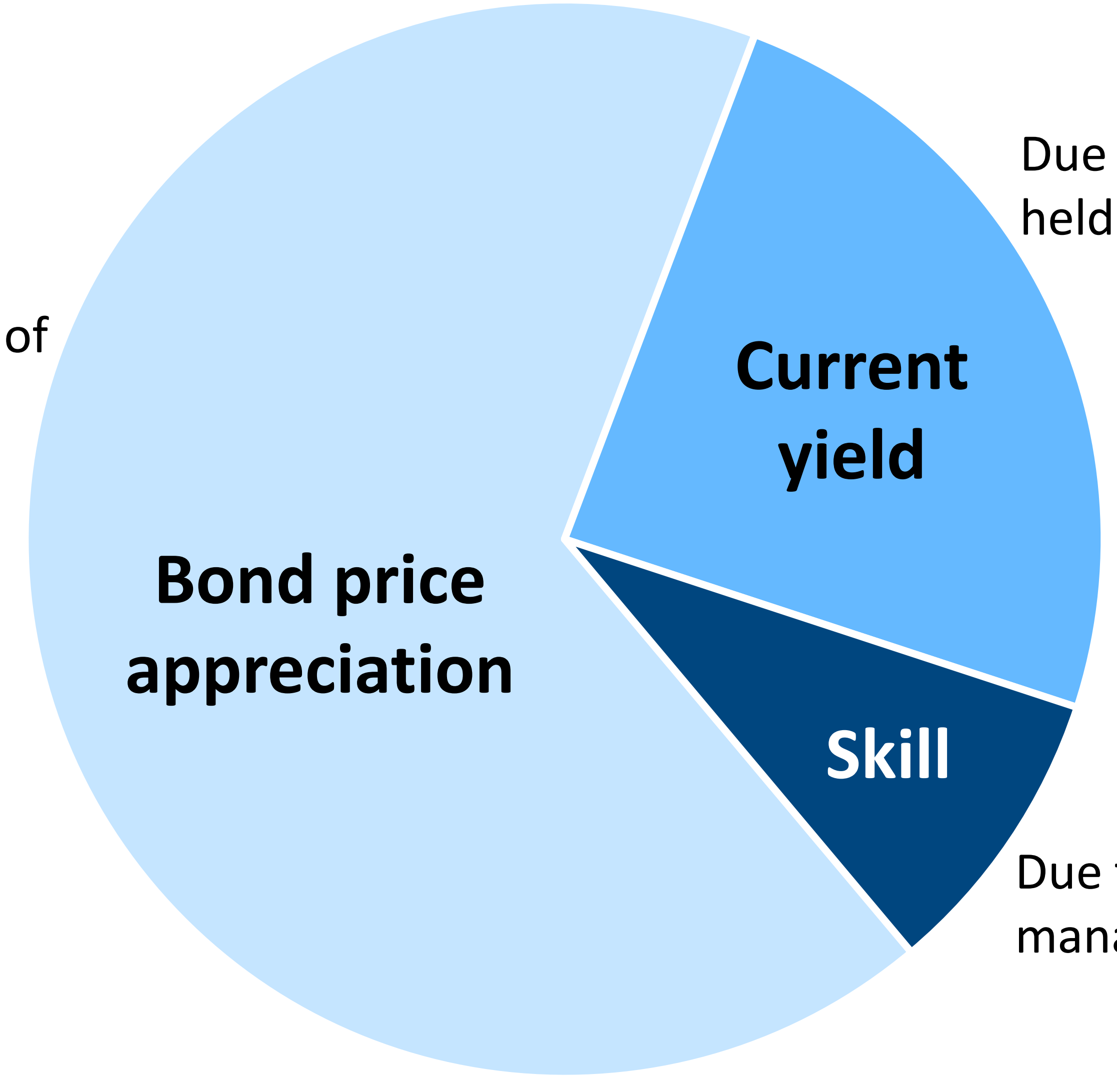
See Disclosure # 9 on the last page

Past performance is explained, primarily by declining interest rates



Where has great performance come from . . . since late-1981

Due to the decline in the level of interest rates since 9/30/1981



Due to the current yield on the bonds held within the portfolio

Due to the bond manager's skill

Great past performance provides NO basis for future success - continued

One of the very best bond funds

Vanguard Long-Term Investment Grade Bond Fund
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Returns other than year-to-date are as of July 31, 2020

But terrible downside risk . . . when interest rates rise

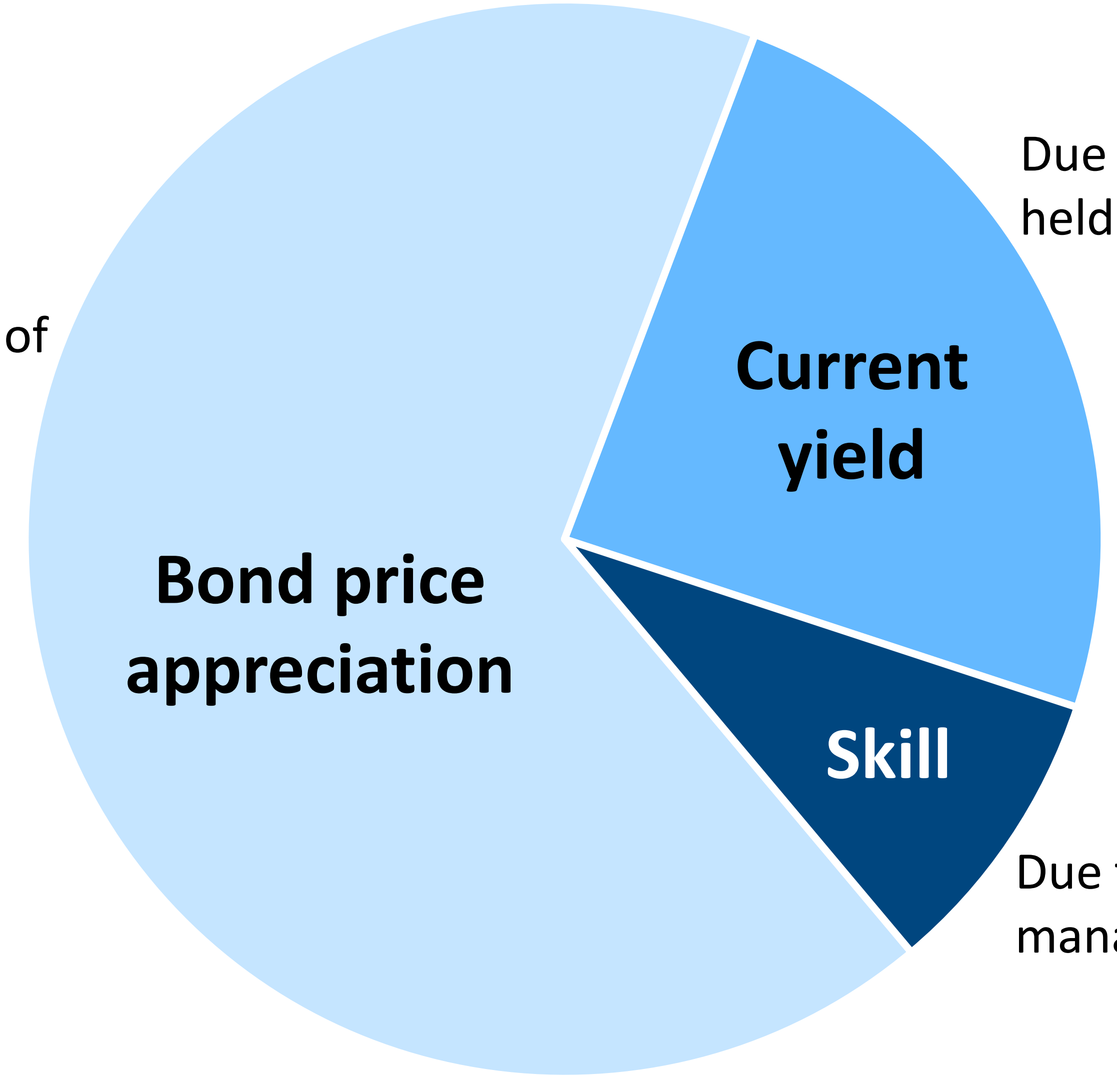
Change in interest rates (from current levels)	Vanguard Bond Fund (VWESX)
-25bps	**+4%**
+25bps	**-4%**
+50bps	**-8%**
+100bps	**-15%**
+200bps	**-31%**
+250bps	**-38%**

Based on where interest rates stood on August 23, 2020
Assumes an instantaneous change in the level of interest rates, i.e., overnight

STOP - Don’t confuse alpha and beta

Due to the current yield on the bonds held within the portfolio

Due to the decline in the level of interest rates since 9/30/1981



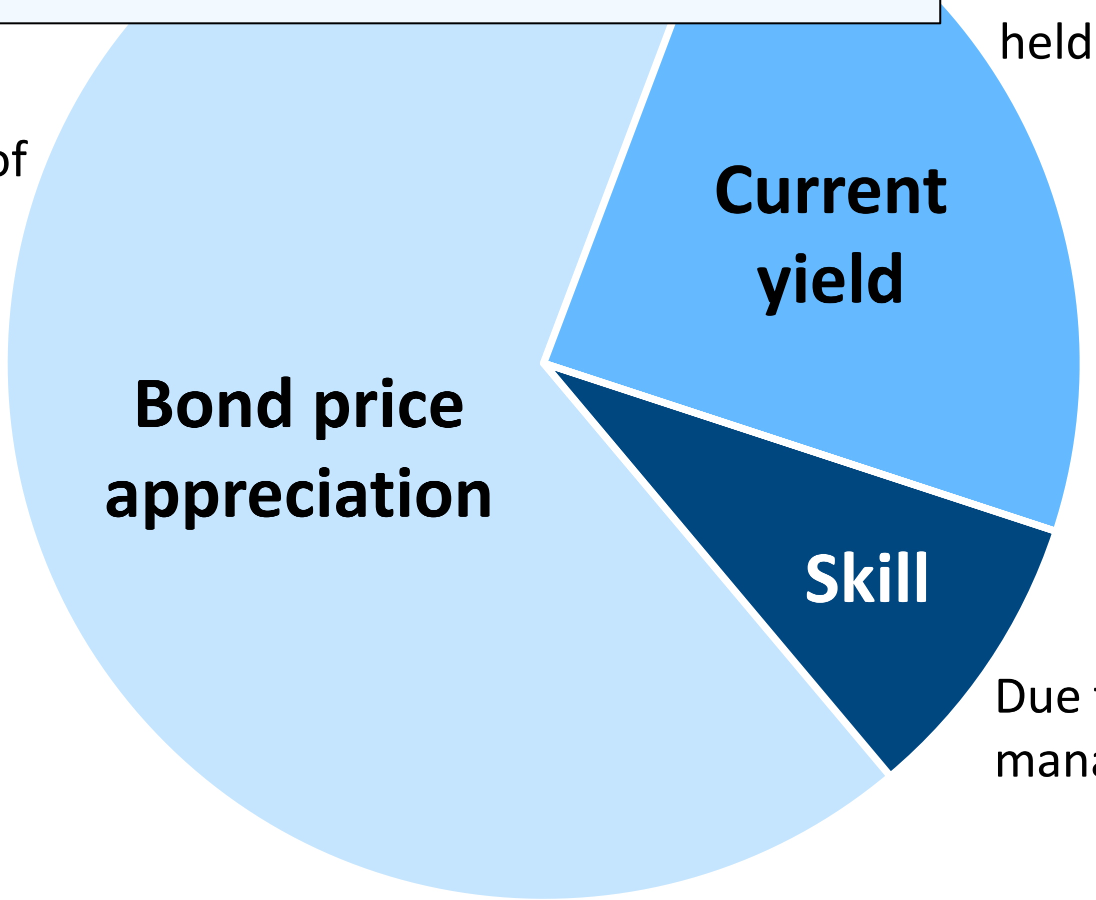
Due to the bond manager’s skill

STOP - Don’t confuse alpha and beta

Don’t confuse a bull market for brilliance

Due to the current yield on the bonds held within the portfolio

Due to the decline in the level of interest rates since 9/30/1981



Due to the bond manager’s skill

How would a simple Treasury portfolio perform?

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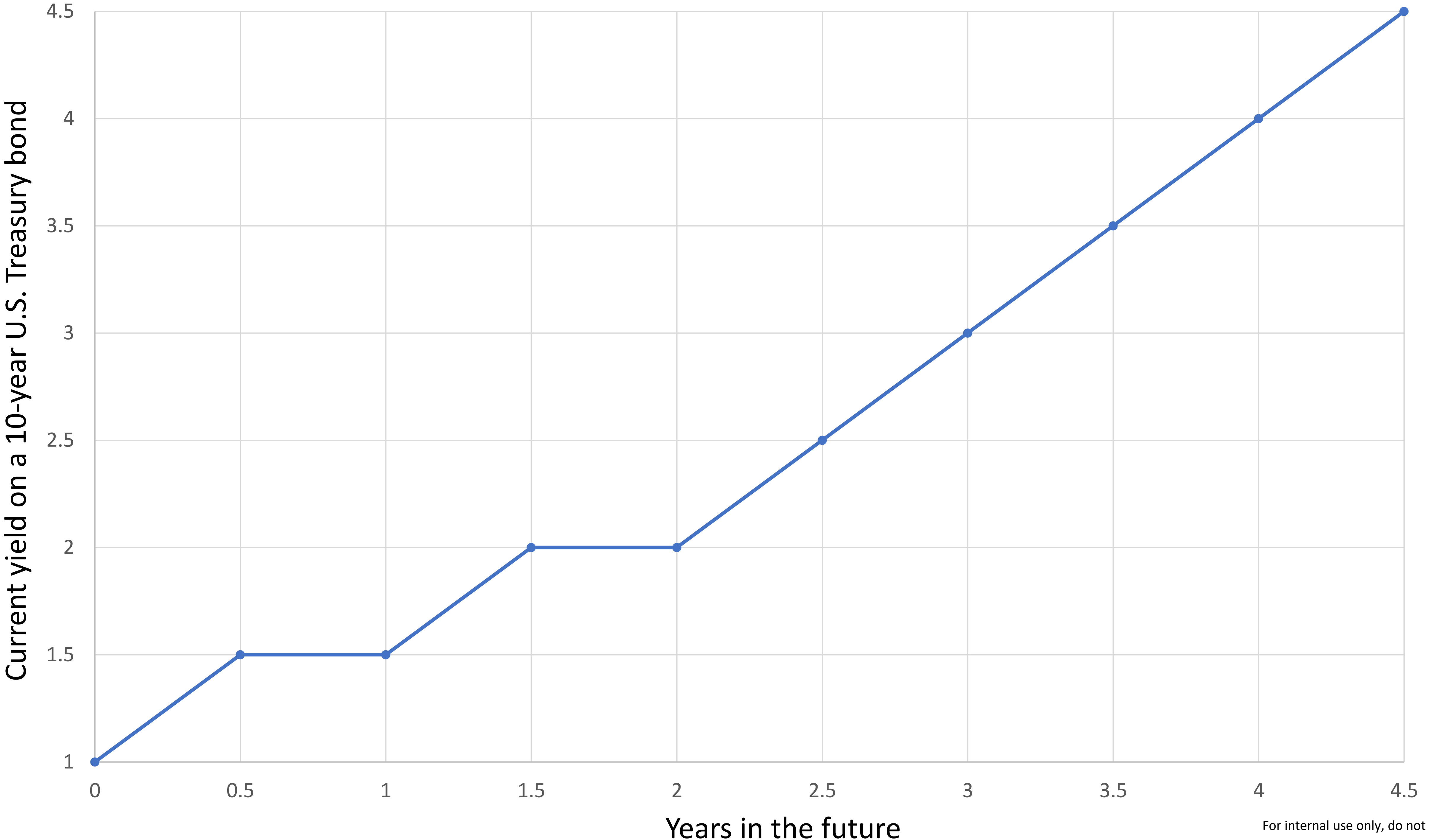
- 100% pure U.S. Treasury bonds
- Maintain simple constant maturity
- Just ten years
- Reinvest every single interest payment
- Never take a withdrawal

- Interest rates rise gradually over 4 ½ years . . . back to a normal sustainable level

If interest rates rise gradually . . . as follows

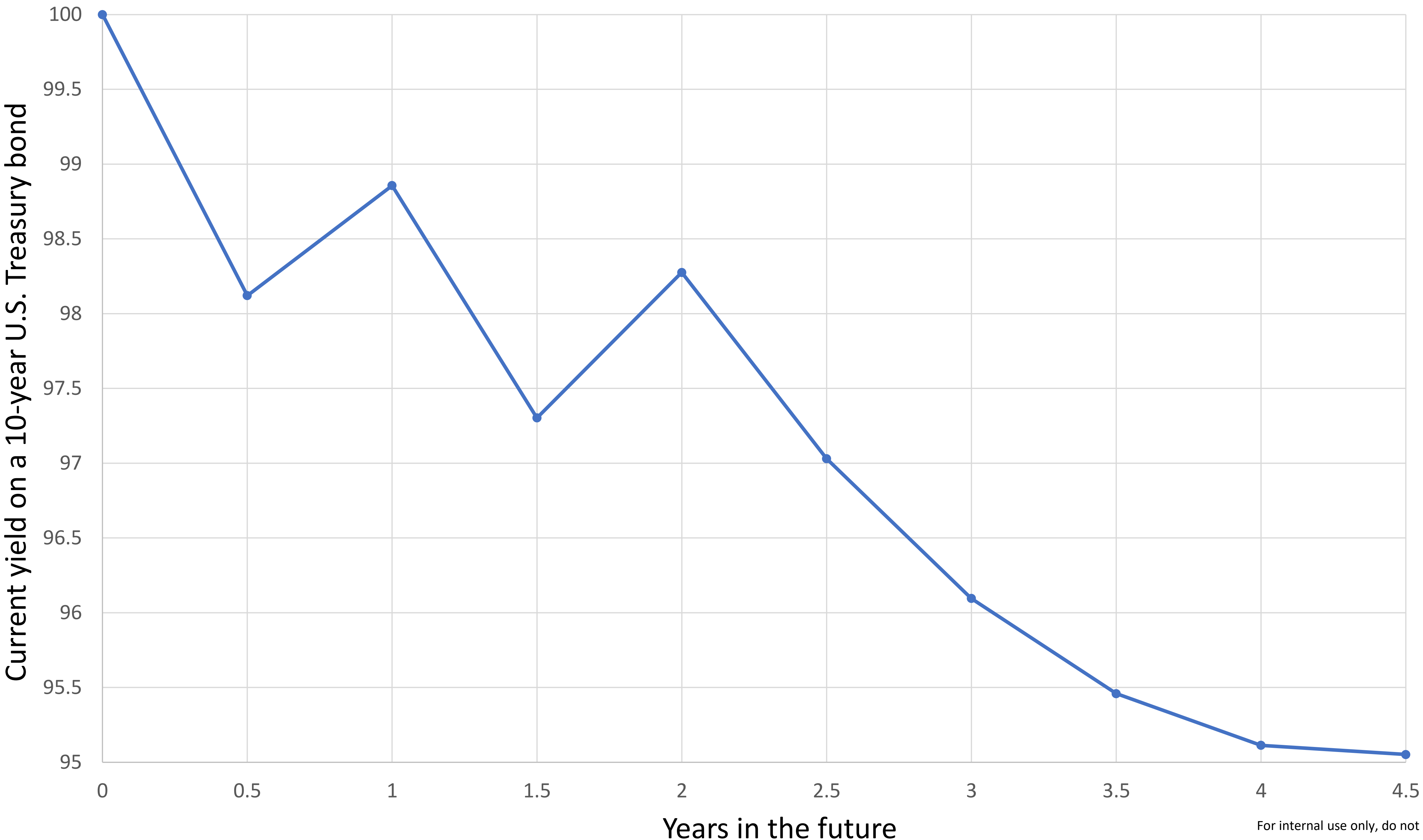


Assume the following

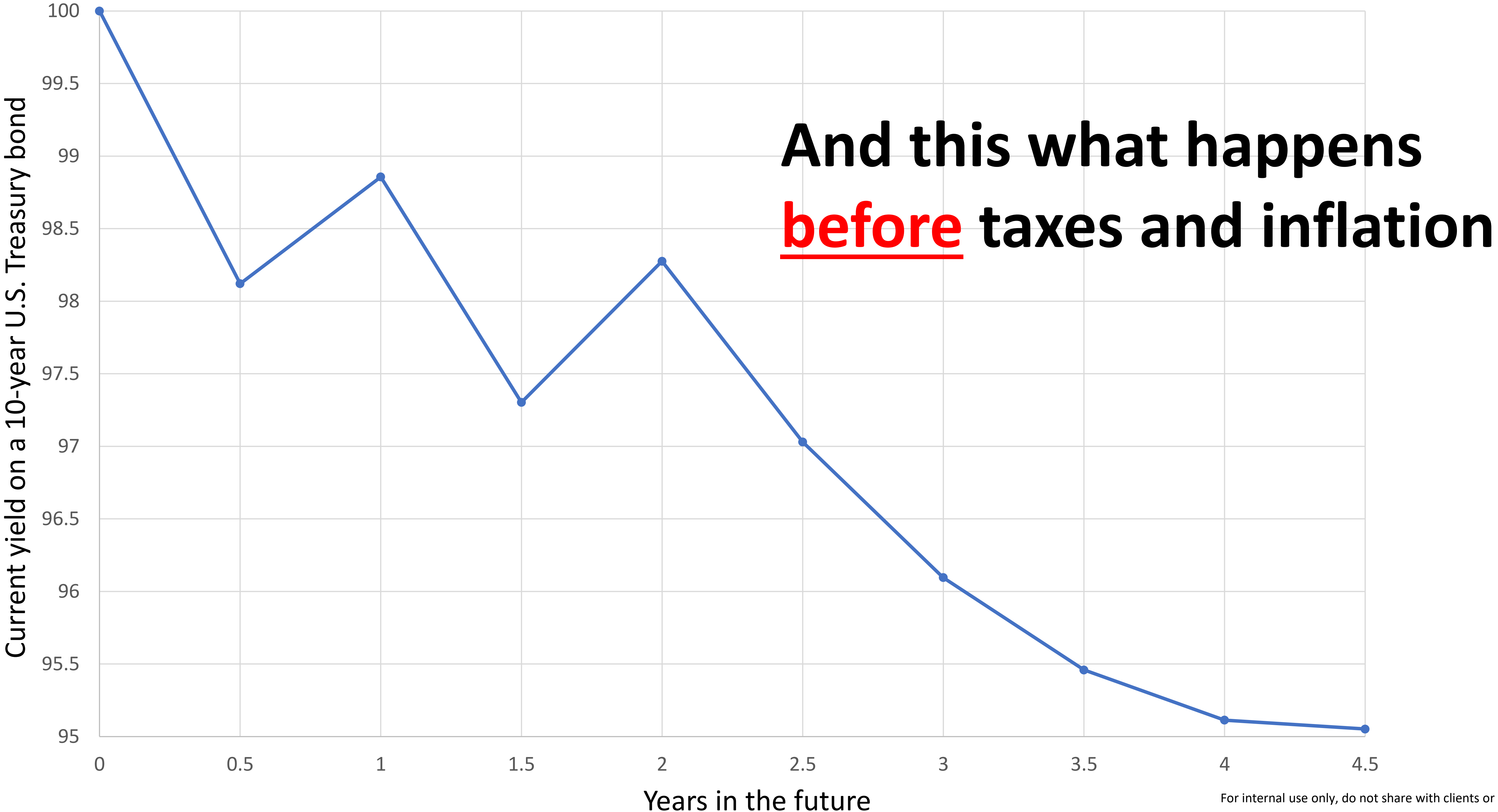
- 10 year U.S. Treasury bond
- Constant and unvarying maturity
- NEVER . . . take any distributions
- Reinvest every single interest payment

- Taxes are zero

The value of your bond portfolio will collapse *!!!*



The value of your bond portfolio will collapse !!!



Impact of a rising interest rate environment

- -5% from falling bond prices
- -12% from inflation
- -5% from taxes . . . . *recall you still have to pay taxes on bond interest*

- Total loss = -22%

Will interest rates rise?

What's the alternative? . . . . that they stay negative?

Inflation? . . . yep

Economics

History Tells Us to Worry About Inflation

Macroeconomics always has its fads: The latest is embracing public debt and not worrying about inflation. But fashions change very quickly.

By Ferdinando Giugliano
February 8, 2021, 10:00 PM MST

A onetime, but large CPI spike, later this year

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Economics

Fed's Kaplan Expects Temporary Inflation Spikes During Recovery

By Catarina Saraiva
February 9, 2021, 7:44 AM MST

- Dallas Fed chief speaks in Bloomberg Television interview
- Watching for excess risk-taking but not seeing systemic threat

The long bond is reacting

2/13/2021 Global Markets See Inflation Breaking Out to Multiyear Highs - Bloomberg

Markets

Global Markets See Inflation Breaking Out to Multiyear Highs

By Elizabeth Stanton, Stephen Spratt, and John Ainger

February 7, 2021, 6:55 PM MST

Updated on February 8, 2021, 10:14 AM MST

- U.S. 30-year Treasury yield briefly eclipses 2% on Monday
- Fiscal, monetary easing plus vaccines provide potent cocktail

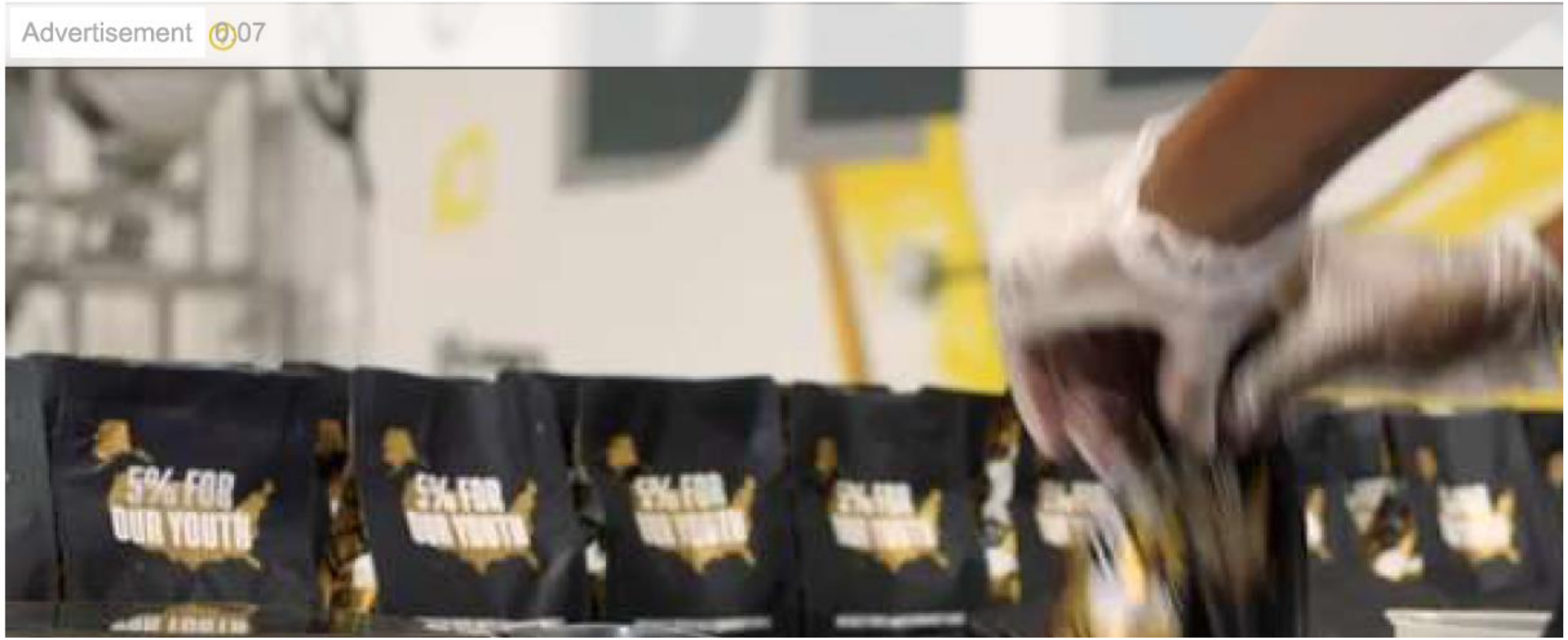
Rising inflation drives interest rates

Investing

Inflation Risk Is Rising. Here's How to Protect Your Investment Portfolio

Buying gold is just one of the available options if talk of rising prices has you worried.

By Emily Cadman, Eric Lam, and Katharine Gemmell
February 9, 2021, 5:00 PM MST



It’s showing up in multiple sectors

Investing

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February 9, 2021, 5:00 PM MST

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MacroStrategy Partnership

Andrew Lees

18 February 2021

Headlines

Ambrose Evans Pritchard suggests oil prices returning to their all-time highs are now probably already baked in the cake due to politics creating demand while starving the industry of investment.

Prices paid by manufacturers . . . and labor costs

BloombergOpinion

From John Authers

Recent macro numbers suggest that inflation pressures are worryingly high, even if they have not yet broken out. Prices paid by manufacturers, as measured by the ISM survey, are showing the greatest pressure in almost a decade. Meanwhile, unit labor costs, measured quarterly, also suggest that labor is getting more expensive, in a way that hasn't been seen in decades. So is the market really right to be so confident that inflation will remain under control?

Inflation is showing up in labor costs

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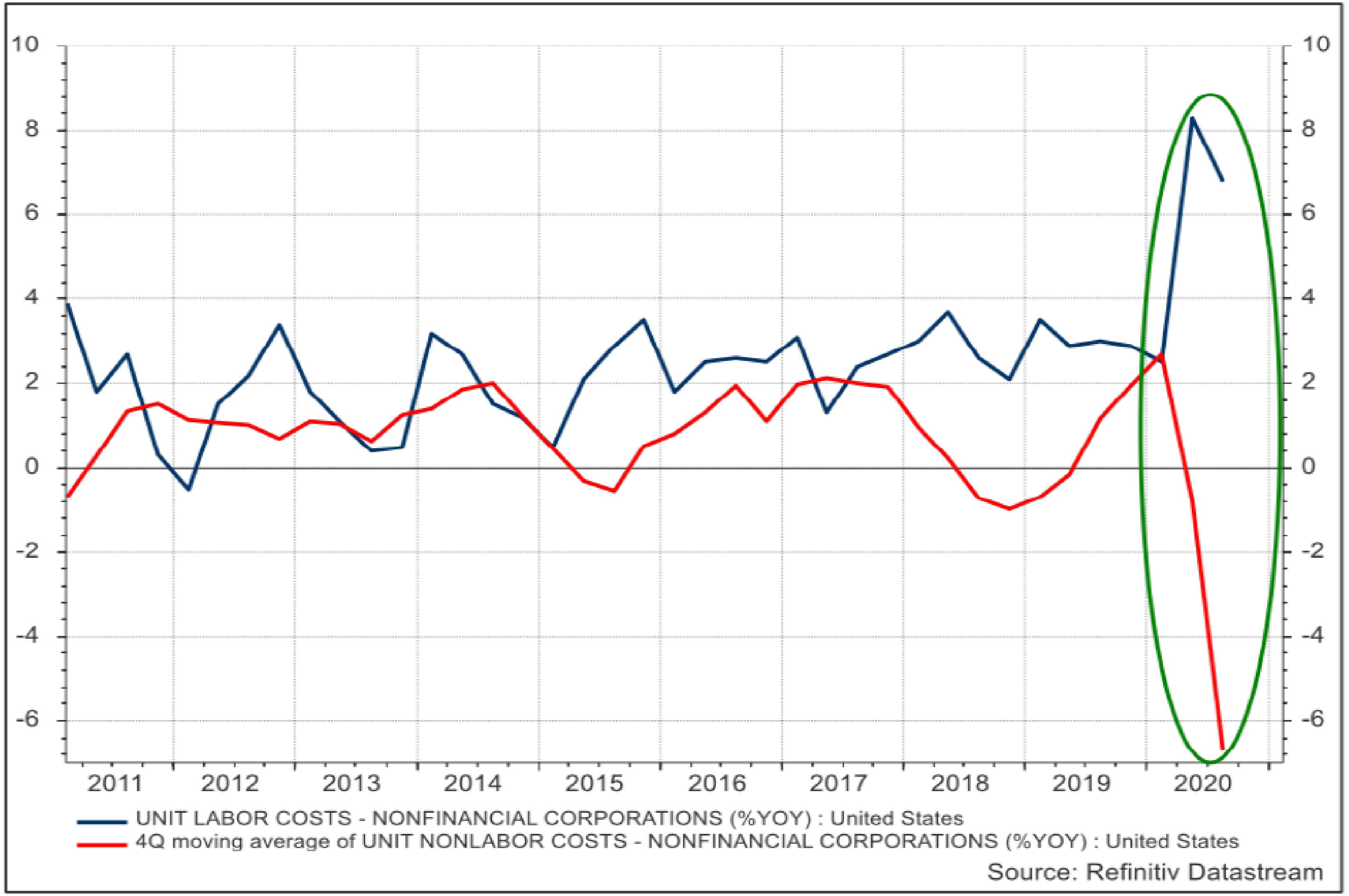
Chart 8: US unit labor & nonlabor costs (%)



James Ferguson at MacroStrategy out of London

Oil has recovered by +300% since its April lows, the same magnitude of increase in eight months that occurred during three years in 2016-18 and that took annual US CPI, which is clearly dependent on the oil price, up by +300bps.

Some industrial metals and basic food commodities are rising faster in price than any time for a decade.

Is it just possible that after 40 years of disinflation, bond investors and Fed staffers alike have just assumed the inflation risk away? Bond yields have less of an inflationary margin of safety than at any time in the last 60 years.

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Dire Bond Returns Have 60/40 Managers Juicing Portfolios With FX

By John Ainger
February 8, 2021, 4:00 AM MST

- Pictet's rationale for currencies focus: 'We made a fortune'
- Volumes suggest more debt investors are chasing allure of FX

It was a dinner conversation with former Federal Reserve Chairman Ben Bernanke in early 2020 that convinced Cesar Perez Ruiz that the golden age of bond investing was over.

The imperative need to get out of bonds . . . just get out

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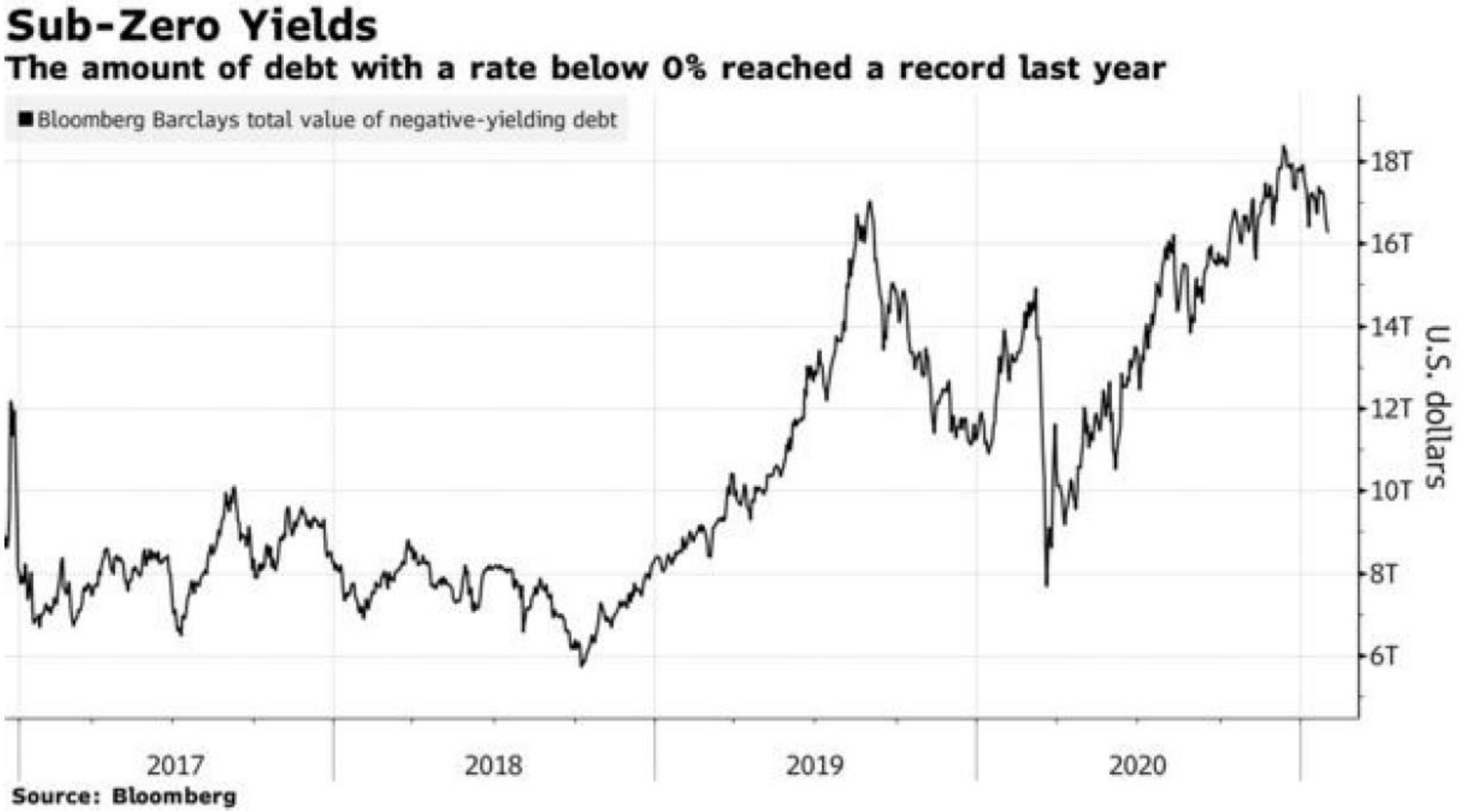
It was a dinner conversation with former Federal Reserve Chairman Ben Bernanke in early 2020 that convinced Cesar Perez Ruiz that the golden age of bond investing was over.

The rate on trillions of dollars in debt had sunk below zero, upending one of the pillars of international finance: that borrowers always pay interest. For Bernanke, it was a deflationary signal that could not be ignored. For Ruiz, chief investment officer at Pictet Wealth Management, it was a sign that he eventually may need to get out of bonds -- and instead turn to FX plays, like wagering on the euro or the yen.

How much is now "negative interest rates"?



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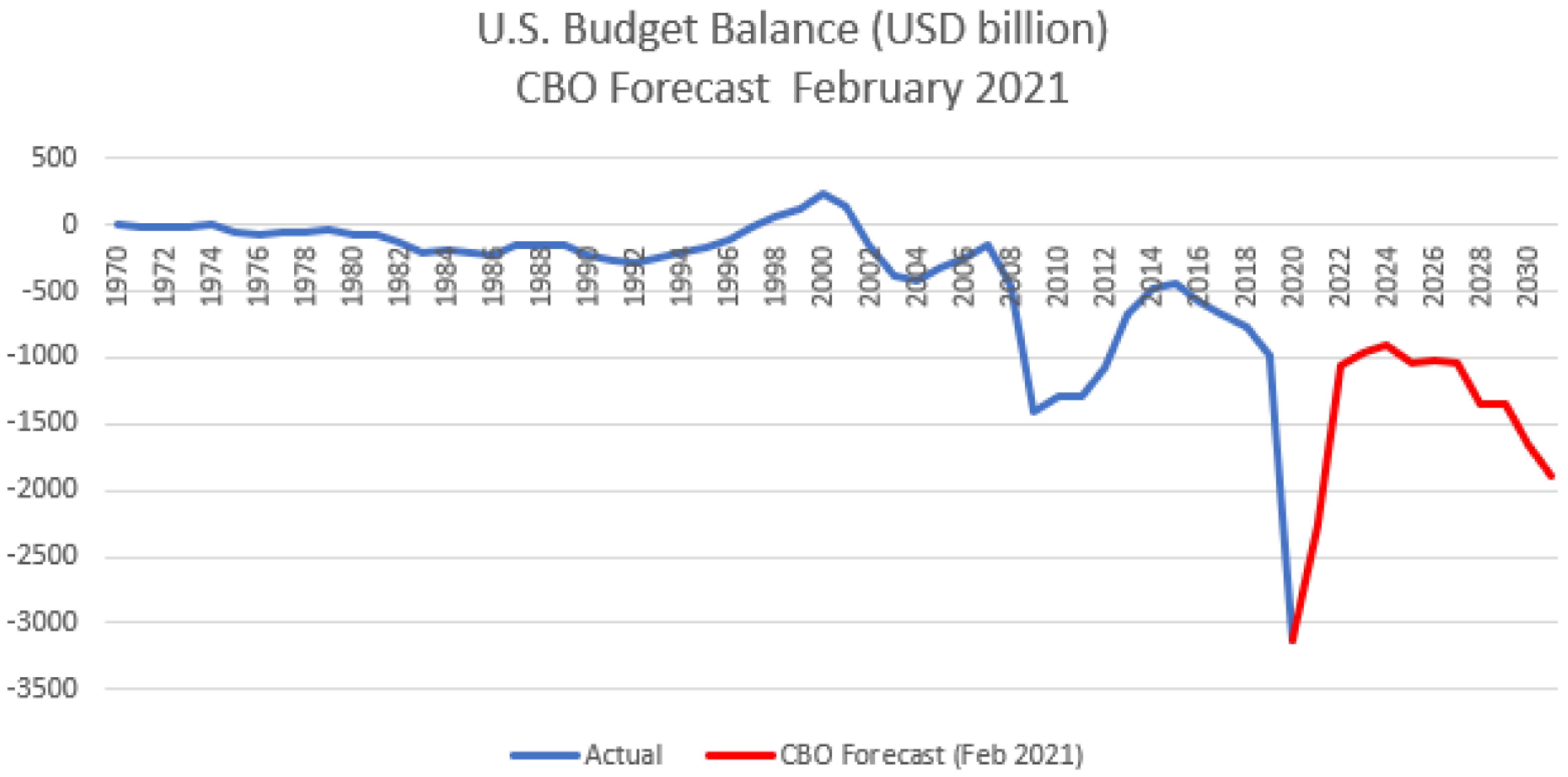
Postscript

Note that none of the inflationary pressures outlined in this note include either the drawdown of the Treasury General Account (TGA), which will pay at least $800bn (and up to $1.1trn) into private sector deposits (money supply) during 2021, nor (more pertinently) the relaxation of restrictions and reopening of the economy which will release the pent-up demand of the additional $3trn of private sector deposits already built up during 2020 and allow them to start flowing through the economy once more. Nor does it include the impact from $1.9trn planned fiscal relief, which will probably be largely funded by the ongoing $1.44trn annualized QE program. Inflation risk, piled on risk, piled on more risk.

An overly optimistic forecast of the annual federal budget deficit



We need effective risk management . . . right now

Warren Buffett's Favorite Valuation Metric Is Ringing an Alarm

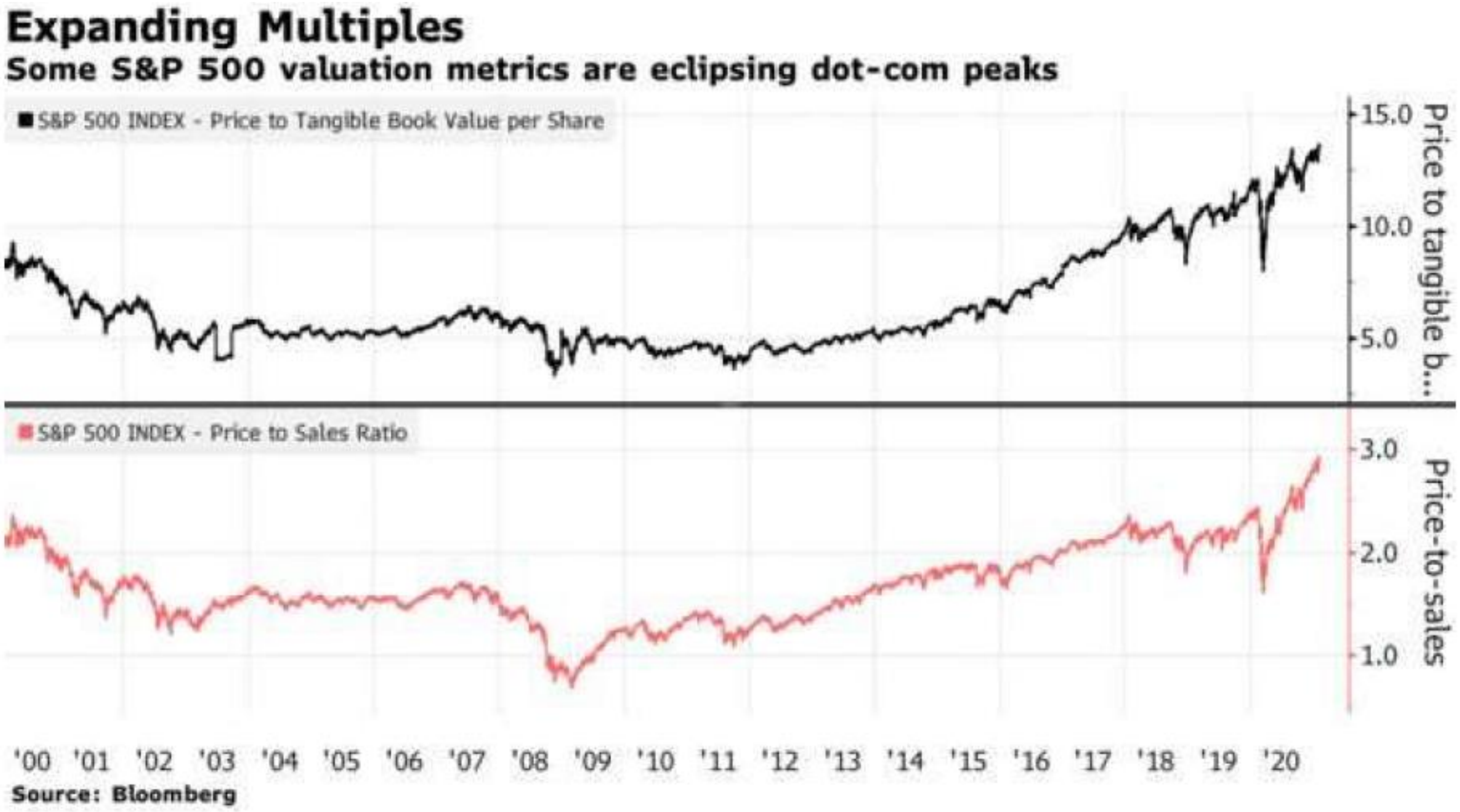
By Michael P. Regan, Vildana Hajric, and Claire Ballentine
February 12, 2021, 2:04 PM MST

- U.S. equity market cap is more than double the nation's GDP
- Indicator highlights 'remarkable mania' in markets: O'Rourke

Valuations are seriously stretched . . . which implies . . .

Source: CurrentMarketValuation.com

More expensive than right before The Great Tech Wreck



What's normal for interest rates?

Long large cycles

Long being like 40 years

Interest rate cycles - seriously long and frighteningly large

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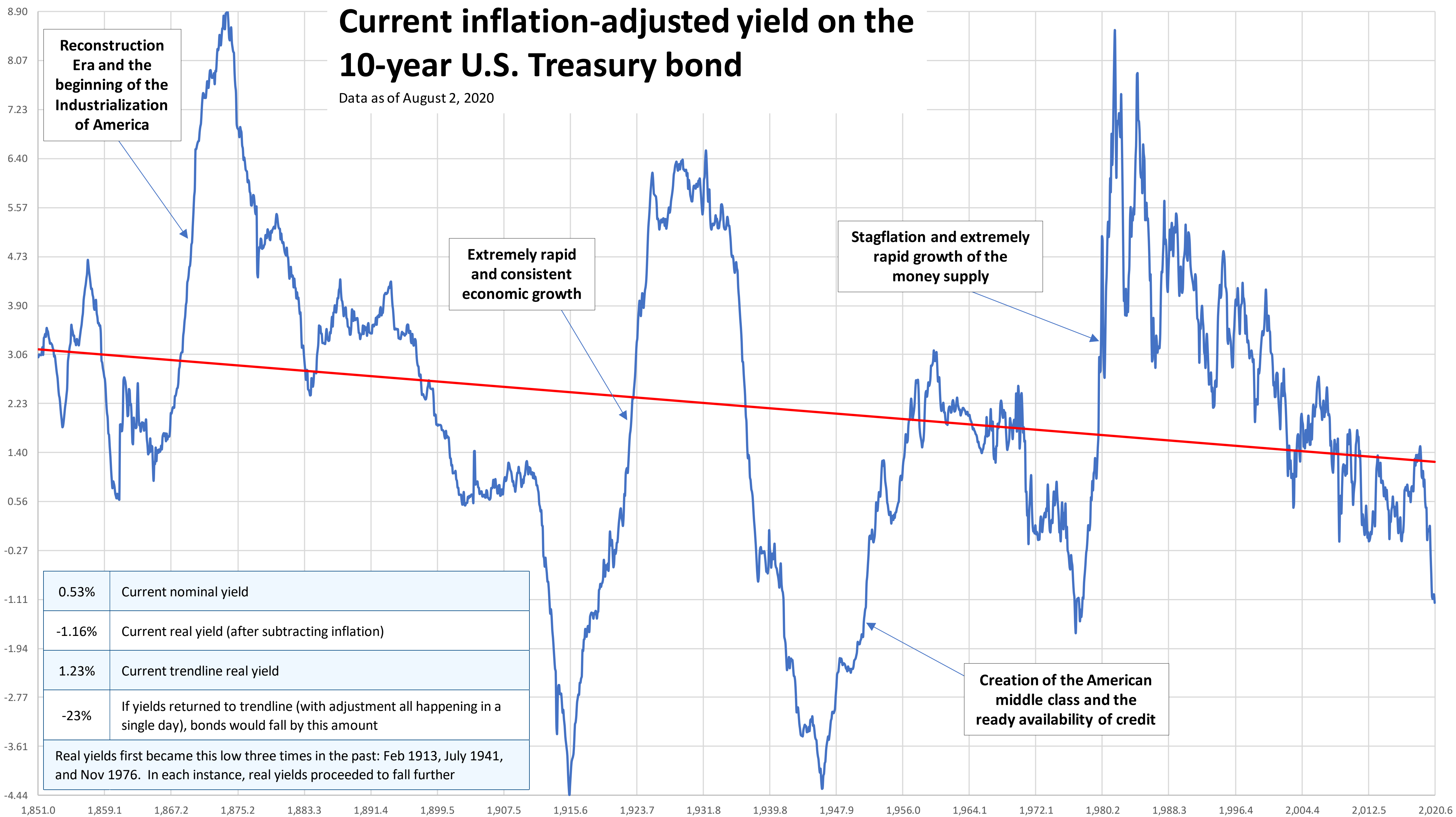
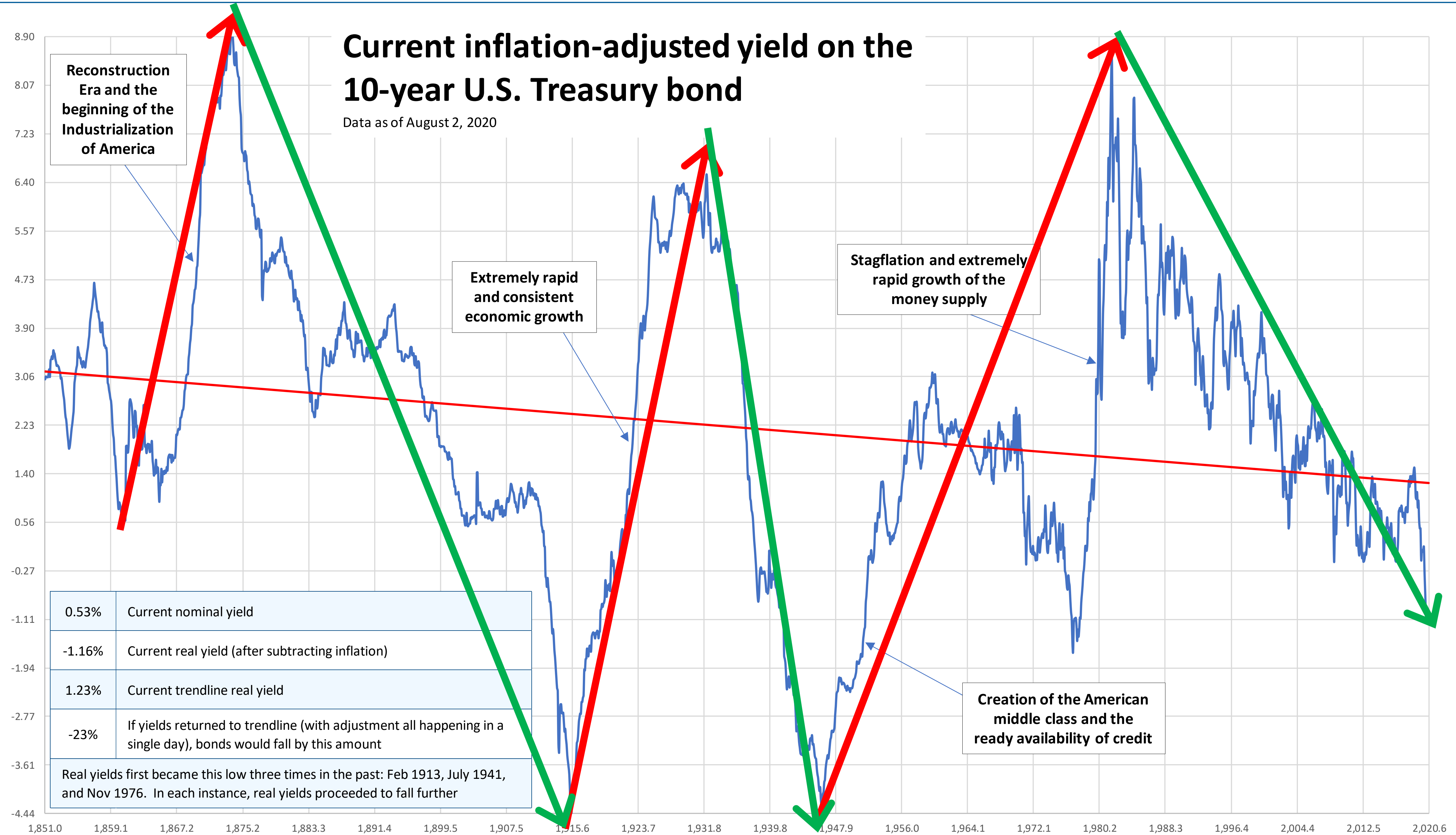


0.53%	Current nominal yield
-1.16%	Current real yield (after subtracting inflation)
1.23%	Current trendline real yield
-23%	If yields returned to trendline (with adjustment all happening in a single day), bonds would fall by this amount
Real yields first became this low three times in the past: Feb 1913, July 1941, and Nov 1976. In each instance, real yields proceeded to fall further	

Interest rate cycles - seriously long and frighteningly large



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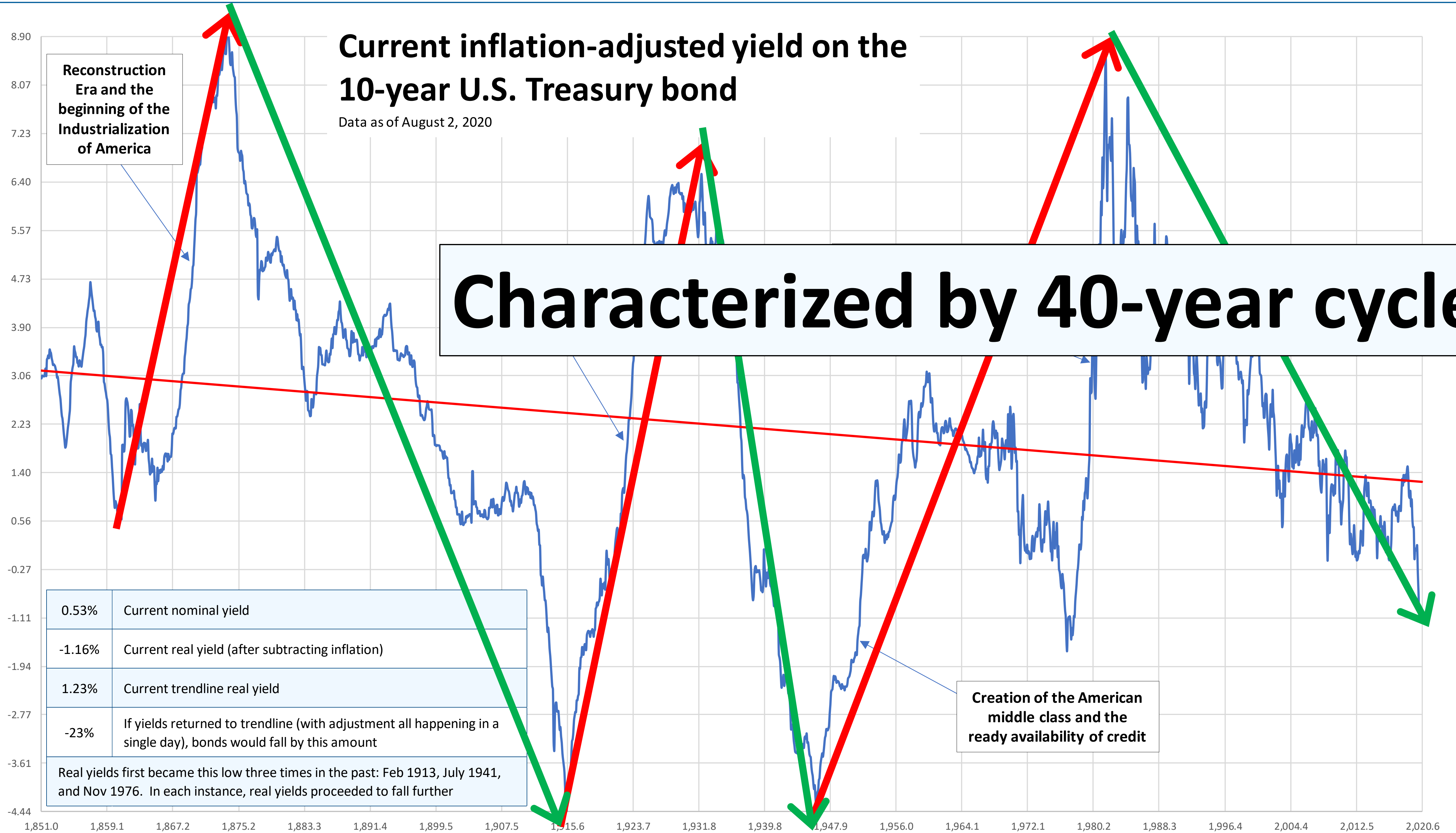

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But the world is different today - and not in a small way

Bonds can’t successfully play their necessary role

What are the possible solutions

As interest rates fall

- Near-zero interest rates have eliminated bond's portfolio functionality
- Cash flow and equity hedging are virtually eliminated
- As rates have approached zero
  - Duration (interest rate sensitivity) has skyrocketed
  - Income has evaporated
  - Ability of bonds to offset stock losses during bear markets is gone

Potential remedies for the future failure of 60/40 portfolios

Tactical asset allocation

While strictly avoiding predicting market direction or turning points

Extremely patient, bottom-up stock picking

Maintaining dry-powder in ultra-short Treasuries

Ownership of commercial real estate

Bricks & mortar

Active bond picking

Virtually impossible to offer a commercially viable product

Pros and cons for each possible solutions

MOST likely to succeed ⟷ LEAST likely to succeed

Tactical asset allocation (sector rotation)	Patient bottom-up stock picking (deep value with dry-powder)	Private non-traded real estate (bricks & mortar)	Active bond picker (mutual fund)
• Continuously adapts and aligns with the changing environment • Greatest opportunity to enhance returns and mitigate bear market collapse • Hunts cross the entire range of possible asset categories	• Tremendous outperformance opportunity for the patient investor • Based on the common sense logic of *“Buying $1 worth of assets for 50¢”*	• Potential to earn attractive premiums by accepting the risks associated with illiquidity, manager-skill, and specific property-types	• Opportunity at three distinct levels: asset-class, sector, and individual issuer
• Does not track any performance index • Terribly tax inefficient • Fails miserably in the short-run (e.g., three or four years)	• Requires a full market cycle (one complete bull and bear market) • Does not track any performance index • Greater week-to-week volatility	• Rising cap rates pose a serious threat • High hidden expense ratios • Requires unusually restrictive manager screening and selection processes • Fails to get you out of stocks	• Virtually impossible to offer a commercially viable mutual fund following such a strategy • Successful active bond managers pursuing such an objective quickly turn into tactical asset allocators • Fails to get you out of stocks

Julex - an expert in tactical asset allocation strategies

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Dynamic Income

December 31, 2020

Overview

- A multi-asset high income solution that tactically allocates between corporate, high yield, emerging market, and government debts, dividend stocks, and REITS.

Objectives

- High Income: Aim to generate higher income on average than the traditional bond portfolio.
- Consistent Returns: Aim to limit downside loss and deliver consistent returns regardless of market conditions.

Facts

Inception Date:
10/01/2012

Benchmark and Category:
Bloomberg U.S. Aggregate Bond Index

Portfolio Manager:
Henry Ma, Ph. D., CFA

Firm AUM (12/31/2020):
$334 M

Investment Process

Dual Model Approach: Use short-term model for one month market expectations, and long-term model for economic factors

Identify Market Regime (Risk-on, Risk-off, Partially Risk Off)
Long-term trend analysis combined with short-term market outlook

→ **Invest in the Strongest Performing ETFs**
Momentum based decision process

→ **Smooth Out the Ride - Reduce Return Volatility**
Volatility weighted portfolio construction

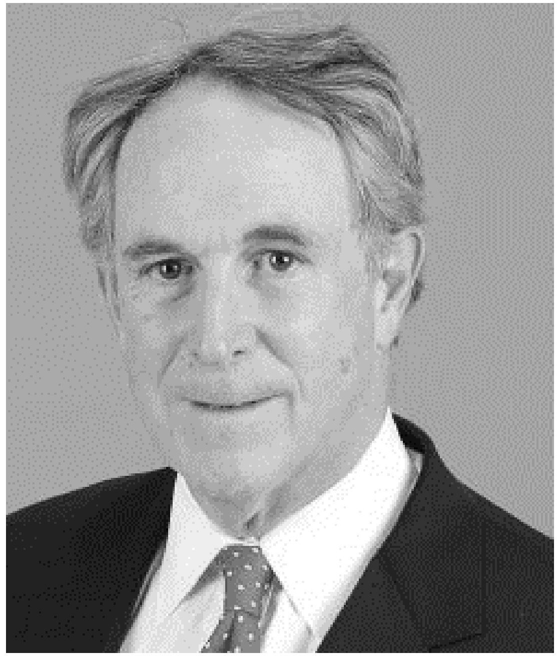
Why tactical asset allocation for bonds?

- Cost effective (low price)
- Perfectly transparent
- Testable
- You can "ask" and "answer" the question: "How would it of performed from *'1966-1976'*"
- Properly constructed, it can
  - Find shelter
  - Find what's producing
  - Nimbly adapt
  - Take advantage of the sub-trends that develop within the unfolding 40-year bear
  - Plays to trending and momentum . . . instead of crystal ball gazing

Last thought - Why did we all use bonds in the past?

- Because an all-stock portfolio is too risky, too volatile
- Bonds were the single most effective way of taming stock's unruly behavior
- Bonds can't work during the coming bond bear
- Therefore . . . We need a new method for taming stocks
- I recommend you give TAA serious consideration
- I guarantee you of one thing . . . *your competitors (other advisers) are doing just that . . . they want your clients*

For more information contact



Jeff Megar, CFA
Email jeff.megar@julexcapital.com
Office 781-772-1378

Brian Phelan
Email brian.phelan@julexcapital.com
Cell 508-527-1431

Bob Peatman
Email bob.peatman@julexcapital.com
Cell 617-875-9316

Important Disclosures

All data and statistics were provided by Global Financial Data, Inc. (unless otherwise noted in/on the graph or chart) at https://finaeon.globalfinancialdata.com/Account/Login

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The risk of loss in trading securities can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. All information posted is believed to come from reliable sources. We do not warrant the accuracy or completeness of information made available and therefore will not be liable for any losses incurred.

Some part of the investment performance shown is HYPOTHETICAL. It is based on the back tests of historical data. Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program.

One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the presentation of hypothetical performance results and all of which can adversely affect actual trading results.

The composition of a benchmark index may not reflect the manner in which a Julex portfolio is constructed in relation to expected or achieved returns, investment holdings, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility, or tracking error targets, all of which are subject to change over time.

No representation or warranty is made to the reasonableness of the assumptions made or that all assumptions used to construct the performance provided have been stated or fully considered.