Quarterly Insights

For Portfolio Diversification, Bonds Never Go Out of Fashion

By Jared Kizer, CFA

When it comes to portfolio diversification, the main purpose of fixed income, or bonds, is to protect the wealth you've worked hard to accumulate. While stocks provide greater potential for growth, bonds help insulate portfolios from the larger price swings of the stock market.

In fact, there's only been one year since 1970 when both global stocks and five-year U.S. Treasury notes produced negative returns, and that year was 2022.[1] So, why did last year prove to be such a challenging one for fixed income investors? The main reason was the significant increase in interest rates – the year-over-year increase in the five-year Treasury rate was the largest in the last 60 years.[2] When interest rates go up, bond prices go down.

Although years like 2022 have been rare, naturally they can lead investors to question the value of fixed income within a diversified portfolio. While there is no perfect way to diversify a portfolio, investing in high-credit-quality bonds with relatively short maturity dates is typically the most reliable way to protect the portfolio from the risk that more volatile investments, like stocks, will experience losses.

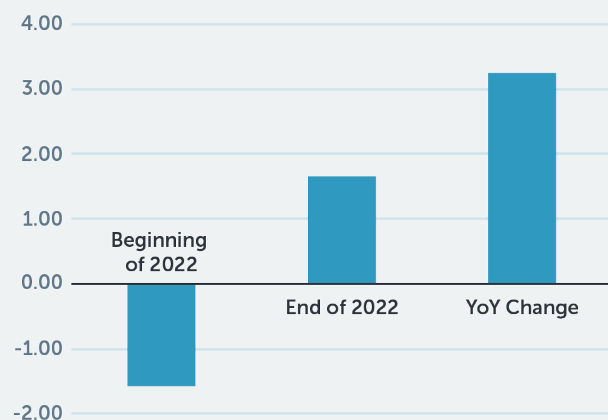
For example, the most secure and creditworthy bonds are those backed by the U.S. government, which is unlikely to fail to repay investors. And a bond with a shorter maturity date – within one to 10 years – is safer because it is less sensitive to changes in interest rates over its time to maturity.

Are Bonds Set to Make a Comeback in 2023?

One silver lining of 2022 is that long-term expected returns for bonds have dramatically improved. As the chart shows, by the end of 2022 the yields on Treasury inflation-protected securities (TIPS) had increased from negative territory to positive.[3] This means long-term expected returns relative to inflation have also gone from negative territory to positive.

While there is no way to know what the future holds, fixed income should remain a strong diversifier against stock market risk, and the long-term outlook for expected returns has significantly improved. That should give investors some comfort that they can still count on bonds to help smooth portfolio returns.

Positive Yields on Five-Year TIPS Have Brightened the Outlook for Bonds



1 Sources: Refinitiv Lipper, DFA Returns Web. Stock index comprises global stocks, a 60% CRSP Deciles 1-10 Index and 40% MSCI EAFE Index. Bond index is the 5-year US Treasury Notes Index.

2 Source: Federal Reserve Economic Data (FRED). Yield on five-year constant maturity Treasury bond from 1963-2022.

3 Source: U.S. Treasury Department's Daily Treasury Par Real Yield Curve Rates.

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Does Investing Internationally Still Make Sense?

By Alex Kluesner

It's a fair question to ask ourselves: should my portfolio be exposed to foreign companies? The answer is nuanced and investor-specific, but ultimately, yes. Buckingham's Investment Policy Committee (IPC) believes an allocation in your portfolio to companies outside of the U.S. is beneficial. Let's look at some of the most common reasons people tend to question their portfolio's international allocation.

Geopolitical Risk

This risk is front of mind for many investors given that the war in Ukraine has been ongoing for longer than a year and shows little sign of resolution. Geopolitical risks, such as a war or health crisis, can affect global companies – and their stock returns – in many ways, including by creating trade disruptions, slowing the economy and weakening local currencies relative to the U.S. dollar. Last year showed the impact: international stocks faced headwinds as the U.S. dollar had its best run in 20 years, which increases costs and lowers profits for businesses operating overseas.[1]

Although geopolitical risks can be worrying for investors, we believe there is no reason to react to the latest news because highly efficient markets incorporate all the relevant, known information into today's stock prices. That's also the reason why your portfolio isn't tactically managed around the timing of different market events; by the time you come across new information, it has likely been baked into current prices. In fact, the IPC believes the best strategy to guard your portfolio against geopolitical risk is to own stocks from as many different countries and regions as possible. By doing so, you will be lowering your country-specific risk, both at home and abroad.

International Business by U.S. Companies

Proponents of a U.S.-only stock portfolio argue that it supplies ample exposure to foreign markets through each company's international revenue streams: according to Morningstar, U.S. companies source approximately 38% of their revenue outside our borders.[2] While this would provide some international exposure, we believe it falls short from a total portfolio diversification viewpoint. One of the big benefits of investing in foreign markets is the opportunity to own shares of companies that focus solely on their local markets, such as grocery chains and local restaurants. Studies show that these companies provide greater diversification benefits than multinational companies, which source revenue from their home markets and internationally.[3]

Also, investing internationally means you own portions of foreign companies that source part of their revenue from the U.S. For example, U.S. consumers provide more than 20% of revenue for companies based in the U.K., Germany, France, Belgium and Taiwan, among others. By not investing internationally, one would forgo the opportunity to take part in the growth and innovation of well-known, multinational companies like LG, Honda, Nestlé, Budweiser and many others.[4]

Recent U.S. Stock Market Performance

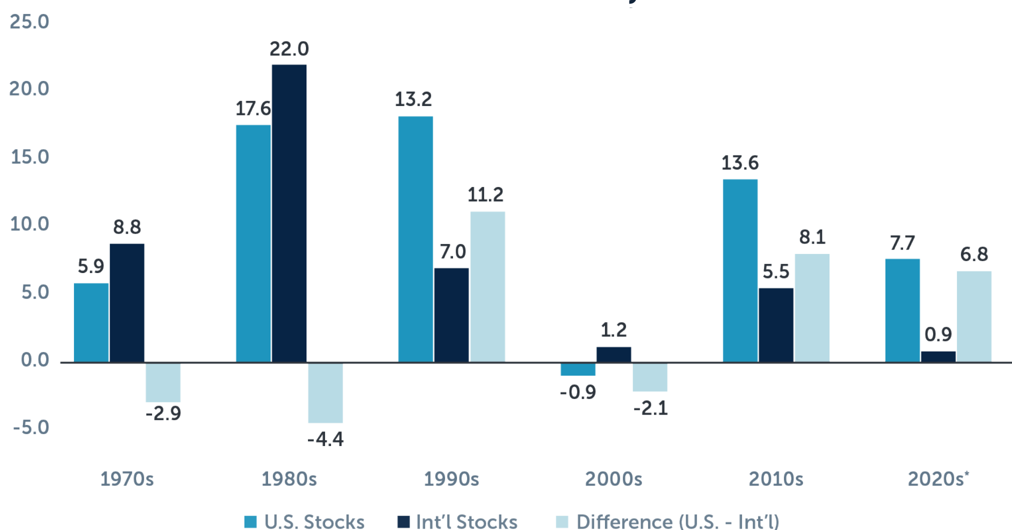
It can be very easy to anchor your expectations to recent performance when evaluating the holdings in your portfolio. Since the 2010s, U.S. stocks have enjoyed a stretch of superior performance compared with their international counterparts. However, this hasn't always been the case. International stocks outpaced domestic stocks in the 1970s and 1980s. And although that trend reversed in the 1990s, the following decade — known as the "Lost Decade" because U.S. stocks lost value during the period — international stocks posted modest gains. This reinforces the fact that over any period, U.S. stocks can outperform their international counterparts and vice versa. And because market timing is often ill-fated, it's best to own stocks from all over the world.

1 Source: Morningstar Inc. "What's the Impact of the Strong Dollar on My Portfolio?" July 2022.

2 Source: Morningstar Inc. "Equity Markets Have Only Become More Global." June 2022.

3 Source: CFA Institute, Financial Analysts Journal. "Mononationals: The Diversification Benefits of Investing in Companies with No Foreign Sales." Second Quarter 2017.

4 Source: Morningstar Inc. "Equity Markets Have Only Become More Global." June 2022.



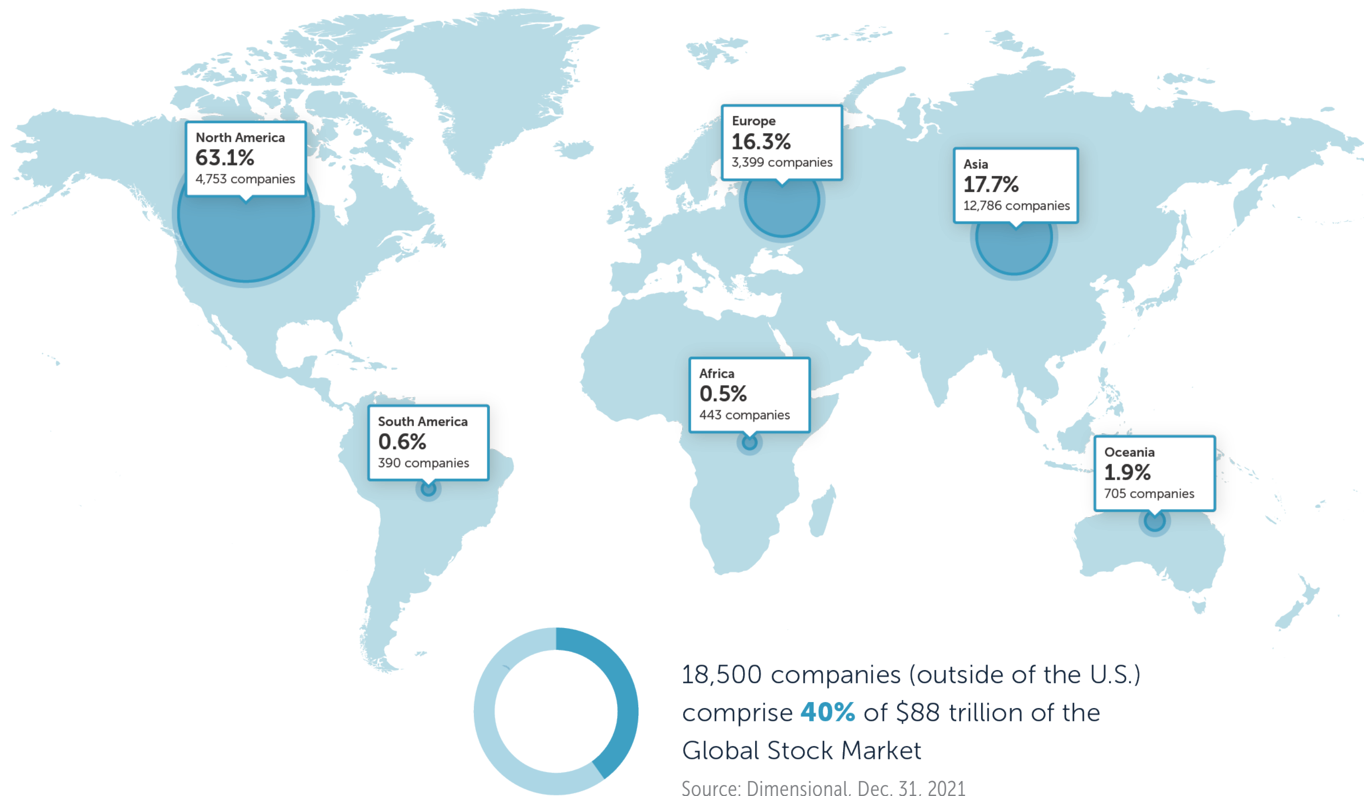
Over any period, U.S. stock returns can be higher than international stock returns and vice versa.

*2020 through 2022.
U.S. stocks are represented by the S&P 500 Index and international stocks are represented by the MSCI EAFE Index (net div.).

Focus on What You Can Control

As investors, we like to think that we can forecast stock market performance with some degree of certainty, but ultimately, global stock market performance is not within our control. Instead, we should focus on the things we can control, such as the types of risk that we take in our portfolios. Taking on international stock market risk in your portfolio provides the potential for diversification benefits, but if this risk makes you feel too uneasy, consult with your trusted advisor to discuss the appropriate level of international stock exposure in your portfolio.

Seeing the Whole Investment World



18,500 companies (outside of the U.S.) comprise **40%** of $88 trillion of the Global Stock Market

Source: Dimensional, Dec. 31, 2021

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Private Equity and the Fear of Missing Out

By Daniel Campbell, CFA

For reality TV fans, one might argue that the private equity world truly took off last year: celebrity Kim Kardashian launched her own private equity firm. As these investments get more media attention, some investors are wondering if this would be a good addition to their portfolio. Although we continue to evaluate this evolving space, the high valuations give us concern on whether this is the time to add private equity to our portfolios.

Over $4 trillion is invested in private equity, more than double the amount 10 years ago.[1]

What is private equity?

Private equity involves investing in companies that are not publicly traded. Most commonly, a private equity firm, known as the general partner, will supplement cash from outside investors with debt to purchase existing public companies, or portions of companies, and take them private through a leveraged buyout. The general partner will set up a new fund every few years, and the group of investors, known as limited partners, commit to staying invested over the fund's life, usually 10 years or longer. Over that time, the general partner uses the capital to buy companies, increase their value and then sell them for a return.

What are the possible benefits?

- Private equity allows access to an area of the market that is otherwise inaccessible to individual investors – companies not on a public stock exchange.
- Private equity appears to have high, stable returns for individual investors as well.

What are the possible risks?

- Private equity general partners determine the value of held companies, and research shows that their price adjustments tend to lag those of public stock markets.[2] In other words, the price stability is mostly contrived.
- The returns for both public and private companies are driven by a similar set of underlying risks, and the returns for an individual investor will be highly dependent upon when they start investing and the general partner they choose.
- Competition has intensified over the last decade, leading to higher valuations and lower estimates of future returns for investors. One study found that private equity deals made in 2021 were done at a 10% premium to the S&P 500, more than double the value of deals done in 2010.[3]
- Private equity investments are highly illiquid, meaning investors are generally unable to sell their holdings for the full value before the end of the fund's life (if they can sell at all).
- Research shows that once you adjust private equity returns for risks, most private equity funds have not provided higher risk-adjusted returns. Rather, the returns look like that of a levered investment in small, inexpensive companies with high debt.[4]

1 Source: Pitchbook. "Global Private Market Fundraising Report." February 2023.
2 Source: Rabener, Nicolas. "Private Equity Is Still Equity, Nothing Special Here. The Journal of Investing." December 2020.
3 Source: Dan Rasmussen, Verdad Capital. "Private Equity: Still Overrated and Overvalued?" May 2022.
4 Source: Rabener, Nicolas. "Private Equity Is Still Equity, Nothing Special Here. The Journal of Investing." December 2020.

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