

Investment Perspectives

A New Dawn for Fixed Income

Key Takeaways

- Higher yields mean renewed relevance for fixed income as an asset class.
- Today's heightened uncertainty creates alpha opportunities for active management, especially from bottom-up security selection.
- Dodge & Cox's investment team has a successful history of building strong long-term performance during periods of short-term uncertainty and volatility.

With the negative news and poor returns coming from bond markets last year, investors may have adopted a defensive crouch when considering the asset class and its role in a broader portfolio going forward. That is a mistake, in our view. We see a substantial silver lining in the cloud that has hung over the bond market over the past year: the cumulative interest rate increases that drove record annual losses have simultaneously returned the asset class to greater relevance going forward. With significantly higher starting yields, the absolute return outlook for fixed income has meaningfully improved relative to the last decade, during which broad market yields averaged 1.7% to 2.4%, compared to 3.7% to 4.7% today.¹ In addition, the elevated uncertainty and volatility in the current environment create potential for active managers employing deep research to generate performance above that of passive or benchmark-linked strategies.

Fixed Income's Long-Awaited Return to Relevance

Why are we optimistic about return prospects for fixed income? In a word, yield. Yield refers to the potential income earned on an investment (or investment portfolio) and is a critical contributor to fixed income total returns (income earned plus price gains/losses on underlying investments).²

Yields are as attractive today as they have been in more than a decade, providing a solid foundation for forward-looking returns given the historically strong relationship between starting yield and subsequent intermediate-term returns. We depict this in two ways: Figure 1 below shows starting yields and subsequent 3-year returns for the Bloomberg U.S. Aggregate Bond Index (BBG U.S. Agg).³ Generally speaking, higher starting yields have led to higher subsequent returns. Figure 2 illustrates the BBG U.S. Agg's rolling annualized 3-year return alongside its yield to worst⁴ on a 3-year lag, effectively connecting the Index's starting yield at time T=0 and its subsequent three-year annualized total return. The tightness of the fit reflects a strong relationship between the two across most market environments, demonstrating the importance of starting yield to intermediate-term total return for bonds.

Contributors



Tom Dugan, CFA
 Director of Fixed Income,
 Investment Committee
 Member, and D&C Board
 Member



Lucy Johns, CFA
 Associate Director of
 Fixed Income, Investment
 Committee Member, and
 D&C Board Member

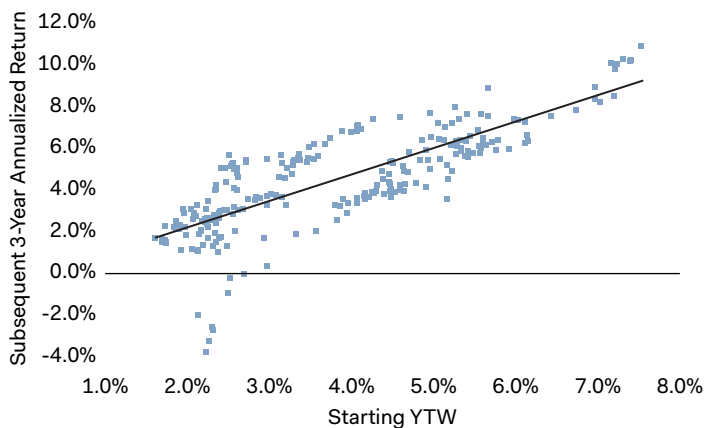


Katie Fast, CFA
 Director of Fixed Income
 Client Service

2022 Fixed Income Lowlights

- Worst calendar-year performance since the BBG U.S. Agg's inception in 1976, sparked by higher rates and wider premia⁵ for credit⁶ and mortgage-backed securities (MBS).
- High levels of volatility and uncertainty, driven by stubbornly high inflation, more restrictive central bank policies, heightened geopolitical risks, and slowing economies.
- High positive correlation with equities, when more typically negatively correlated.

Figure 1. Bloomberg U.S. Aggregate Bond Index: Starting Yield to Worst versus Subsequent 3-Year Annualized Total Return (December 2002 through December 2022)



Source: Bloomberg Index Services.

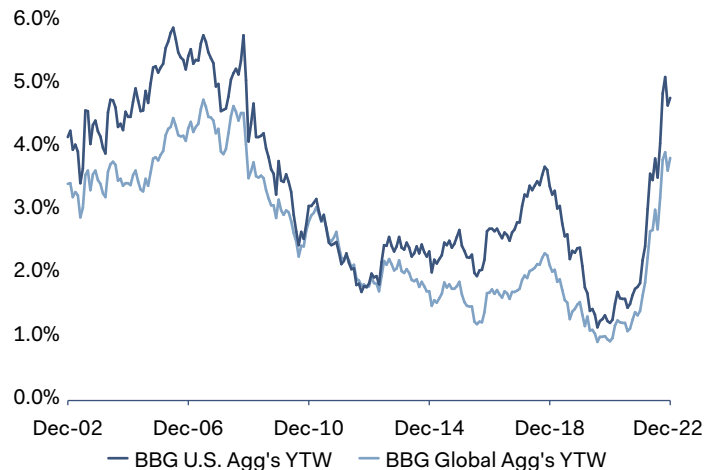
Figure 2. Bloomberg U.S. Aggregate Bond Index: 3-Year Return and Yield to Worst (3-Year Lagged)



Source: Bloomberg Index Services.

Recent yields, broadly speaking, look as attractive as they have in well over a decade. Figure 3 shows that the yield to worst on both the BBG U.S. Agg and the Bloomberg Global Aggregate Bond Index (BBG Global Agg)⁷ are at their highest levels since the Global Financial Crisis and nearly triple the levels of just one year ago. Given that the Federal Reserve has tightened financial conditions significantly, inflation shows nascent signs of moderating, and the economy is slowing,

Figure 3. Bloomberg U.S. and Global Aggregate Bond Indices: Yield to Worst



Source: Bloomberg Index Services.

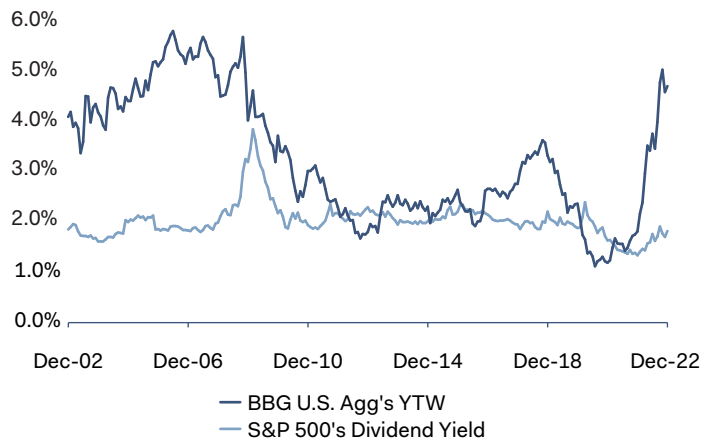
we see a strong possibility for longer-term interest rates to stabilize or decline from current levels, enabling beleaguered bond investors the opportunity to harvest today's higher yield levels. Furthermore, even if rates rise from current levels, higher yields can provide a more substantial cushion against associated price declines.

Higher fixed income yields also make the asset class more compelling versus other asset classes, including equities. Figure 4 on the next page shows the yield of the BBG U.S. Agg over the last 20 years alongside the dividend yield of the S&P 500 Index.⁸ While neither provides a complete picture of the return outlook for their respective asset classes going forward, recent rate increases have transformed this relationship, tilting it in favor of fixed income, which could justify higher fixed income allocations in diversified portfolios.

Alpha Opportunities in Uncertain Times

On top of overall return prospects for fixed income assets, we believe conditions for alpha generation (i.e., incremental return above that of an Index or passive strategy) are favorable. Alpha sources typically emanate from three primary differences versus a benchmark: 1) individual issuer and security differences; 2) sector allocation/weighting differences (e.g., Credit, Agency MBS); and, 3) duration⁹ and key rate exposure differences. While duration differences have driven our strategies' strong relative returns in 2022, sector

Figure 4. Bloomberg U.S. Aggregate Bond Index's Yield to Worst versus S&P 500's Dividend Yield



Source: Bloomberg Index Services.

allocation and individual issuer and security differences have been Dodge & Cox's most durable and largest contributors to outperformance over time, and we are enthused about their prospects for alpha generation. Reflecting this enthusiasm, we were quite active in 2022 taking advantage of dynamic valuations and elevated uncertainty.

After spending much of 2021 in "fully valued" territory, valuations in the major, non-Treasury sectors of the bond market (i.e., Credit and Agency MBS) cheapened significantly in 2022. We responded by materially increasing allocations to both sectors.

- Macroeconomic uncertainty and the prospect of a recession have weakened credit valuations. Using careful bottom-up security selection, we increased our fixed income strategies' overweight positions in credit by 5-10% in 2022. Despite an uncertain future, we are bolstered by the confidence that comes from decades of deep-rooted "through the cycle" research and our investment team's focus on fully vetting portfolio issuers across a range of scenarios, both optimistic and pessimistic.

A Note about Duration Positioning in 2022

We have lengthened portfolio duration across our strategies to where, in most cases, we are quite close to benchmark duration. Why?

- Higher and more attractive nominal and real rates following 2022's significant interest rate increases;
- Higher income-earning potential;
- Fair valuations—our "base case" view on rates is now more closely in line with market expectations; and,
- Recession risk and the possibility of significant interest rate declines.

- The combination of much higher mortgage rates and the Federal Reserve's pullback from direct MBS market support have driven Agency MBS dollar prices (broadly) to their lowest level in 40 years. With vastly reduced prepayment uncertainty¹⁰ and inexpensive valuations, we've added to this area and are optimistic about its prospects.

Our deep, fundamental, bottom-up oriented research and security selection catalyze these changes in sector weightings and drive highly differentiated intra-sector composition in our portfolios versus market benchmarks. For example, the BBG U.S. Agg includes over 1,000 individual Credit issuers, whereas our "core" strategies, even with our sector overweights, feature 50 to 70 issuers. This greater concentration has historically allowed us to focus our positioning on individual credits that, in our view, have the most appealing risk/reward profile. Similarly, our in-depth research within the Structured Products/Agency MBS sector meaningfully differentiates our exposures from those of the broad market.

Looking Ahead

Today's decade-high yield environment could lead to strong fixed income asset class returns over the next several years. Our "base case" expectation is for long-term interest rates to remain in their current vicinity, if not fall, over our three-year investment horizon, which would be a constructive environment for fixed income investors.

Beyond meaningfully more attractive total return prospects, bonds also seem likely to resume their more traditional portfolio role—liquidity source, income generator, capital preservation provider, and diversifier to traditionally riskier asset classes like equities—after a difficult year in which surging inflation drove positive correlation across most asset classes.¹¹ As we believe inflation and volatility will decline over the coming years, we would expect fixed income to perform well and reassert its role in diversified portfolios. Such a development would be welcomed by investors making asset allocation decisions, particularly for those who lowered their fixed income or increased their cash allocations as a result of 2022's challenging market environment.

Finally, our long-term track record rests in no small part on investing deliberately and opportunistically through periods of high volatility to lay the groundwork for future outperformance. We believe the key to successfully navigating such periods comes down to prioritizing three tenets long-held by Dodge & Cox:

- A long-term investment lens through which to view risk and reward;
- Conviction in our in-house research effort, combined with a valuation discipline providing the confidence to adjust positioning as we move through a market cycle; and,
- A team-based approach, which ensures that each portfolio holding and theme is continuously evaluated with appropriate amounts of skepticism, optimism, and humility.

These characteristics provide the foundation for us to make informed investment decisions as we seek to build a portfolio with durable yield, a necessary ingredient to delivering strong returns over an investment cycle. We are optimistic about the coming years, both in our ability to add value in today's market environment and the greater potential for the fixed income asset class to deliver positive, more attractive returns to investors.

The above information is not a complete analysis of every material fact concerning any market, industry, or investment. Data was obtained from sources considered reliable, but Dodge & Cox makes no representations as to the completeness or accuracy of such information. Opinions expressed are subject to change without notice. Information regarding yield, quality, maturity, and/ or duration does not pertain to accounts managed by Dodge & Cox. The above returns represent past performance and do not guarantee future results. Dodge & Cox does not seek to replicate the returns of any index. The actual returns of a Dodge & Cox managed portfolio may differ materially from the returns shown above. This is not a recommendation to buy, sell, or hold any security and is not indicative of Dodge & Cox's current or future trading activity. The securities identified are subject to change without notice and may not represent an account's entire holdings.

Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance, L.P. and its affiliates (collectively "Bloomberg"). Bloomberg or Bloomberg's licensors own all proprietary rights in the Bloomberg Indices. Bloomberg does not approve or endorse this material, guarantee the accuracy or completeness of any information herein, or make any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, shall have no liability or responsibility for injury or damages arising in connection therewith.

-
1. All data is as of December 31, 2022 unless otherwise stated. Average yield to worst (YTW) for the Bloomberg indices over the past 10 years: Bloomberg U.S. Aggregate Bond Index: 2.4%; Bloomberg Global Aggregate Bond Index: 1.7%. YTW on December 31, 2022: BBG U.S. Agg: 4.7%; BBG Global Agg: 3.7%.
 2. All else equal, with no change to interest rates or spreads in a given period, and no defaults, the yield is effectively the total return. Naturally, interest rates and risk spreads are not static: look no further than 2022 where U.S. Treasury rates rose 200-400 basis points (bps) and credit and mortgage-backed securities' (MBS) risk premia soared.
 3. The Bloomberg U.S. Aggregate Bond Index is a widely recognized, unmanaged index of U.S. dollar-denominated, investment-grade, taxable fixed income securities.
 4. Yield to worst (YTW) is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.
 5. Yield premium refers to the difference in yield between a comparable-duration Treasury security and that of a non-Treasury (i.e., corporate bond or MBS).
 6. Credit refers to corporate bonds and government-related securities.
 7. The Bloomberg Global Aggregate Bond Index is a widely recognized, unmanaged index of multi-currency, investment-grade fixed income securities.
 8. The S&P 500 Index is a market capitalization-weighted index of 500 large-capitalization stocks commonly used to represent the U.S. equity market.
 9. Duration is a measure of a bond's (or a bond portfolio's) price sensitivity to changes in interest rates.
 10. With the prevailing mortgage rate near multi-decade highs following the massive interest rate increase in 2022, nearly all existing mortgage holders lack incentive to refinance. Given this development, the fundamental risk in Agency MBS—convexity (i.e., duration variability driven by changes in prepayments)—has declined to very low levels.
 11. Against equities, bonds have a 20-year correlation of 0.15, and volatility that is much lower, even within the backdrop of historic rate volatility within the past year. In 2022, the correlation between bonds and equities spiked to 0.66.