

# ABR Dynamic Funds' Series on Stagnation Solutions: Part 8

## U.S. Treasuries

### Introduction

In the first installment, we noted that, at the time this series was written, the 10-year U.S. Treasury yield was only about 1.5%. We also noted that the 10-year yield has been a decent indicator of the upcoming annualized return over the next 10 years. Should investors even bother with U.S. Treasuries? Should they even bother with any duration risk?

It's tempting to answer no. However, this installment will present the sometimes overlooked counter arguments, the arguments for keeping U.S. Treasuries and duration risk. To be clear, the purpose of this installment is not to argue against any adjustments to treasury exposure. Some adjustments likely make sense. The purpose is just to present the case against completely jettisoning U.S. Treasuries and duration risk.

*This installment has nothing to offer investors who are 100% convinced a significant rate rise is imminent. In that case, duration risk may not make sense.*

### 10+ Year U.S. Treasuries

U.S. Treasuries are expensive by historical standards. There's no denying that fact. Not surprisingly, a 10-year yield of 1.5% has historically implied that 10-year U.S. Treasuries would return about 1.5% annualized over the next decade, without much regard for the path of rates over that decade. At first glance, that implication isn't very appealing. However, what follows are 3 simple arguments for possibly maintaining some U.S. Treasury exposure and duration risk.

1. *10+ year U.S. rates have the potential to stay low or drop even lower.*

Despite treasuries being expensive by historical standards, interest rates in the U.S., at the time of this writing, are still not particularly low compared to some other developed economies. Additionally, we have learned over the past decade both of some of the various forms quantitative easing (Q.E.) may take and of the flexible nature of the zero lower bound.

2. *Many other investments also have disappointing outlooks over the next decade.*

Despite treasuries being expensive by historical standards, at the time of this writing, many other investments are expensive by historical standards too. Put another way, approximately 1.5% per year from treasuries sounds terrible compared to the S&P 500's annualized return over the past decade, but this series is for those investors who expect a much lower return from the S&P 500 over the next decade. As we have noted throughout this series, an S&P 500 CAPE of about 30 has implied an upcoming annualized S&P 500 return of about 3% over the next decade. If the expected return difference is only 1-2%, then the opportunity cost of maintaining some treasury exposure may be low.

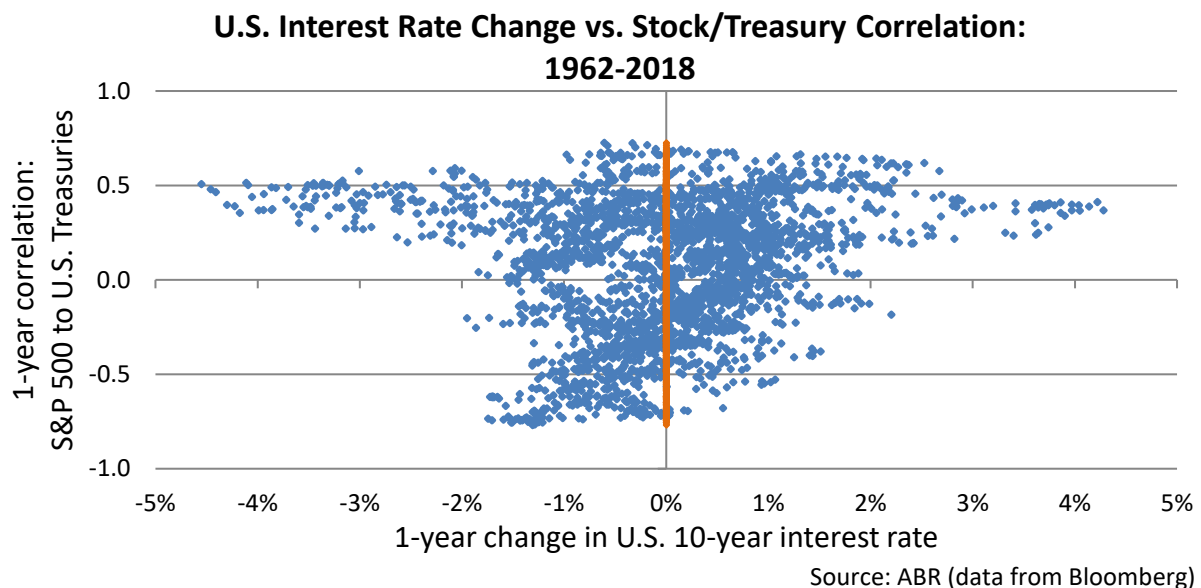
3. *10+ year U.S. Treasuries still potentially offer significant diversification value.*

Despite treasuries being expensive by historical standards, they have historically been one of the few hedges, or even the only hedge, against deflationary shocks in many portfolios. They have also been a

diversifying allocation to the S&P 500. That diversification value has been present in periods of both rising and falling interest rates.

To illustrate, the following graph shows the 1-year change in the U.S. 10-year interest rate (X-axis) vs. the correlation between 10-year U.S. Treasuries and the S&P 500 during that same 1-year period (Y-axis).

There is little, if any, discernable relationship between the change in interest rates and the stock/treasury correlation from 1962 to the present. In other words, U.S. Treasuries have offered diversification value to the S&P 500 both in years of rising rates and in years of falling rates. This result may be noteworthy to investors who are worried about (but not absolutely convinced we are facing imminent) rising rates.



To put the diversification argument another way, yes, it is likely that shorter duration treasuries offer a higher Sharpe ratio and are more appealing in a vacuum than longer duration treasuries, especially with the U.S. rate curve as flat as it is at the time of this writing. There is plenty of research to support that conclusion. However, we think it's important not to optimize each allocation in a vacuum but rather to optimize each allocation for how it complements the rest of a portfolio. ***Shorter duration treasuries likely offer a higher Sharpe ratio than longer duration treasuries, but a portfolio with longer duration treasuries may offer a higher Sharpe ratio than a portfolio with shorter duration treasuries, partially as a result of the "flight to safety" dynamic, or the expectation of lower rates and more Q.E., when stocks drop.*** The following excerpt from installment 18 of our series on portfolio construction addresses this often-overlooked perspective:

Smoothing and increasing returns are appealing goals. However, focusing on these goals within each component of a portfolio only served to increase the portfolio's [relative] concentration in equity behavior. **Remember the goal is not to smooth and increase the returns of the individual components of a portfolio but to smooth and increase returns of the overall portfolio.** These are two separate goals, and, perhaps surprisingly, optimizing individual components in this way can often be counterproductive to the overall portfolio.

**We cannot overstate how important this point is, and how many investors overlook it. If a component is selected for its ability to diversify (i.e. be different from) equity behavior, then that component often should not itself be diversified and optimized *as though it were an entire portfolio instead of a component of a portfolio.***

Once again, this installment was not an argument against modest adjustments in treasury exposure and duration risk. It was just a presentation of counterarguments to some of the calls we have heard for entirely eliminating duration risk or, sometimes, even for shorting U.S. Treasuries.

This installment was also not meant to suggest anything about the timing of the next rate increase or decrease. The perspective in these installments has been decade-long, without suggesting short-term entry or exit points.

*Next Week's Preview: The next installment is the conclusion.*

#### Notes/Disclosures

Some of the indices may contain some hypothetical results. There are inherent limitations to hypothetical results. Past performance does not guarantee future results. No index presented in this installment is representative of any strategy at ABR Dynamic Funds, LLC. It is not possible to invest directly in an index. The information presented in this installment does not constitute a complete analysis of any index or strategy, and this installment contains no recommendation to buy, sell, or hold any investment. All data was obtained from sources believed to be accurate; however, ABR Dynamic Funds, LLC cannot and does not guarantee the accuracy of such data.

The correlation to stocks and treasuries was calculated as the negative value of the correlation between the S&P 500 index and the 10-year U.S. interest rate.

The charts pertaining to interest rates contain autocorrelated data. Readers should not assume a certain level of statistical significance (or lack thereof) based on a chart.