Prescient
INVESTMENT MANAGEMENT

Is there still a place for fixed interest instruments in an overall portfolio?

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In the realm of retirement planning, the strategic allocation of assets becomes paramount to ensure a stable and secure financial future. Fixed interest instruments, often referred to as fixed income or bond investments, have long been recognised as a cornerstone of conservative portfolio construction.

Against this backdrop, it's worth considering the contemporary role fixed interest instruments should play within retirement portfolios by analysing their merits and drawbacks while examining why the advantages tend to outweigh the disadvantages. International evidence also provides guidance on the impact of fixed income assets on overall portfolio volatility.

Fixed interest instruments encompass a range of debt securities issued by governments, corporations, and other entities. These securities, including government bonds, corporate bonds, and Treasury Bills, etc. offer regular interest payments to investors and return the principal amount upon maturity. Such instruments are renowned for their stability and predictability, two qualities that hold particular significance in a retirement portfolio context.

One of the key advantages of incorporating fixed interest instruments in a retirement portfolio is their ability to provide a consistent stream of income. This regular income stream can serve as a dependable source of cash flow during retirement, supplementing other sources, such as social security or pension payments. This aspect proves vital as one uses various sources to attempt to mitigate longevity risk, which pertains to the possibility of outliving one's savings.

Furthermore, fixed income investments often exhibit a low, or at times negative correlation, with equities. Simply put, this talks to instances when a stock market experiences volatility and fixed interest instruments do not follow the same path, with certain fixed income investments showing relatively stable profiles.

Our research shows that a well-diversified portfolio, which includes fixed income assets, exhibits lower volatility over the long term, contributing to a smoother financial journey in retirement. To address the question of whether including fixed income assets increases or decreases overall portfolio volatility, international evidence provides valuable insights.

A 2021 study by Vanguard, a prominent investment management company, examined the historical performance of various portfolios in different market conditions. The research demonstrated that incorporating fixed income assets reduces the overall portfolio volatility while still allowing for respectable long-term returns. This evidence suggests that the presence of fixed interest instruments provides stability without sacrificing significant growth potential.

However, the inclusion of fixed interest instruments is not without risk, or its own downsides. In a low interest rate environment, the potential returns from fixed income investments might be comparatively modest, potentially failing to keep pace with inflation.

This poses the risk of eroding purchasing power over time. Additionally, while we have seen fixed interest instruments exhibit lower volatility than equities, they still carry a level of risk, particularly with respect to credit risk (i.e., the possibility of the issuer defaulting on interest or principal payments) and interest rate risk (i.e., the impact of changing interest rates on bond prices). Balancing these factors becomes essential in constructing a holistic retirement portfolio.

It is our view that fixed interest instruments continue to hold a crucial place in modern retirement portfolios and that the advantages of fixed interest instruments tend to outweigh their disadvantages within a comprehensive retirement portfolio. The advantages of stable income, risk mitigation, and diversification far outweigh their drawbacks, although challenges such as low yields and interest rate risk must be carefully considered. As individuals seek financial security and income sustainability, the strategic inclusion of fixed interest instruments emerges as a pivotal strategy for navigating the complexities of retirement planning in the contemporary landscape.

About the author

Conway joined Prescient in February 2021 as Head of Credit. As the custodian of the Prescient credit process, and Portfolio Manager across the credit offerings, his responsibilities include continuously refining, implementing and managing its philosophy and process, with a focus on delivering on portfolio return objectives. He is also responsible for determining the long-term strategic objectives of the Credit team, building skills and synergies in conjunction with the other senior members of the investment team.

Conway has worked in the industry since 2009 and previously held positions at Old Mutual SA (2007-2009); OMIG Central Research (2009-2012) and Futuregrowth Asset Management (2011-2020) – where he was the Joint Head: Unlisted Credit.

He holds a BBusSc (Hons) and CTA, both from the University of Cape Town, is a qualified Chartered Accountant and completed a Masters in Philosophy (Development Finance) at University of Stellenbosch Business School (USB). He also holds the CDFA designation, as well as directorships at various companies, which is supported by his accreditation achieved through the African Director's Programme (University of Stellenbosch). Conway also holds an eMBA (Valar Institute).

Outside of work, his interests and hobbies include reading, sports (rugby, cricket and football), hiking, community involvement and 4x4-ing.

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