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WAR IS SELL: WHAT INVESTORS GET WRONG ABOUT GLOBAL CONFLICTS AND THEIR IMPACT

Geopolitical events like military or economic conflicts can affect stock markets in many ways. These events are normally widely followed by investors. We believe current market prices quickly incorporate expectations about the effects of these events on economies and companies. Our investment approach centers on using information in current market prices rather than trying to outguess them. If markets stay open and continue to function normally, we generally continue investing our portfolios according to our usual process. We believe that the most effective way to mitigate the risk of unexpected events is through broad diversification and a flexible investment process. This philosophy applies to other crises, like natural disasters, social unrest, and pandemics.

However, geopolitical events sometimes lead to restrictions on investors' ability to trade in specific stocks or on certain exchanges. One way is through government sanctions. In recent days, the US and other western governments have issued sweeping new sanctions directed at Russia.

The international funds we most often recommend to investors are currently underweight in Russian securities and have been dating back to at least 2014, following Russia's annexation of Crimea. Additionally, those funds halted further purchases of Russian stocks in January 2022. Furthermore, Russian investments in those funds are denominated in US dollars, not Russian rubles. As of February 28, 2022, Russian equities represented between 0.07% to 0.42% of the international equity mutual funds and ETFs we recommend, compared to 1.59% in the MSCI Emerging Markets Index.[1]

In another recent example of government sanctions, the US issued executive orders in 2020 and 2021 that prohibited US persons from investing in certain Chinese companies. The weeks and months after the original order took effect in November 2020 were a period marked by uncertainty, as fund managers sought clarity on the scope of the restrictions and the exact list of sanctioned stocks.

In some cases, geopolitical events have led to temporary market closures, impacting all stocks in a certain market for a period of time. For example, on June 27, 2015, Greece closed its stock market after defaulting on its government debt. The Athens Stock Exchange stayed closed until August 3 of that year. During the Egyptian revolution of 2011, the Egyptian Stock Exchange closed after January 27 and remained closed for over a month. Unplanned market closures are not limited to emerging markets. In 2019, the Tokyo Stock Exchange closed for 10 days after Japanese Emperor Akihito abdicated the Chrysanthemum Throne. And lest we forget, in 2001 the New York Stock Exchange closed until September 17 after the September 11 attacks on the World Trade Center.

These types of market disruptions are not new, and the form that they take can vary. We've seen other examples

over the decades, including currency repatriation restrictions in Malaysia in 1997, the introduction of capital controls in Argentina in 1999, and a successful coup d'état in Thailand that led to a market closure in 2006.

As is typical in any other instance of fear and uncertainty, many investors react to such events with panic, selling assets as soon as they are able, usually after a precipitous price drop. We've seen it before and have yet to see a situation where panic selling has proven to be the right move for long-term investment success.

The Value of Flexibility

Flexibility is valuable in managing portfolios through these events. No two events are the same, but common themes are uncertainty and rapid change. The diversified nature of our portfolios is important in allowing us this flexibility. If we are shut out for a period of time in a market or in certain stocks, we have many other investments that are still trading across multiple other eligible countries and securities.

Unlike traditional index funds, the investments we recommend are not constrained to follow the actions of a benchmark during these times. Deletions from benchmarks in the wake of geopolitical events typically follow a similar pattern as other index rebalances. The index provider announces the deletion date in advance, and funds seeking to mirror the holdings of that index must sell the deleted securities at the market close on that date. Seeking to track the index limits a manager's options regarding what actions to take and over what time frame. It may also result in demanding liquidity in specific stocks at the same time as other managers who are also seeking to track the same index fund.

For example, on January 7, 2021, MSCI announced it would drop China Mobile, China Telecom, and China Unicom from certain benchmarks effective at market closing prices the following day as part of a larger set of moves by major index providers to remove sanctioned Chinese stocks from their indices. Together these stocks represented more than 0.5% of the MSCI Emerging Markets Index. Funds tracking that index would need to sell their entire positions in those stocks at the market close on January 8 if they wanted to minimize their tracking error vs. the index. In fact, on that date, all three stocks traded at their lowest closing price for the week and closed higher every day in the week that followed.

While the managers of the funds we use also divested those three stocks, they did so the following week and over several days to take advantage of the price rebound that occurred after buying and selling returned to equilibrium.

Planning for the Unexpected

Investors in global equity portfolios inevitably face periods of geopolitical tensions. Sometimes these events lead to restrictions, sanctions, and other types of market disruptions. We cannot predict when these events will occur or exactly what form they will take. However, we can plan for them by investing in diversified portfolios that build flexibility into their investment process.

—Dimensional Fund Advisors

[1] Numbers are preliminary and subject to change.

Source: Navigating Geopolitical Events by Karen Umland, Dimensional Fund Advisors, March 1, 2022.

ALL EYEZ ON P: WHAT WILL POWELL DO NEXT?

US consumer prices were up 7.9% for the year ending February 2022, the largest annual increase since January 1982.[1] Against this macroeconomic backdrop of inflation, the monetary policy response of the US Federal Reserve has become the center of attention for many US and global fixed income investors.

With Fed officials recently signaling a more hawkish policy stance[2] including Fed Chairman Jerome Powell's March 21, 2022 announcement that the Fed will take "necessary steps" to curb inflation, some market participants might predict that bonds will underperform cash and that longer-duration bonds will underperform shorter-duration bonds. Thus, they might choose to shift their allocation from bonds to cash or favor shorter-duration bonds over longer-duration bonds.

As these narratives have gained media attention, this might be a good time to examine the relation between the federal funds rate, global bond performance, and term premiums.

The federal funds rate is the overnight interest rate at which one depository institution (like a bank) lends to another institution some of its funds that are held at the Federal Reserve. The Fed has a committee that meets regularly to set the target for the federal funds rate. Bond prices

and yields reflect the aggregate expectations of all market participants, including opinions on how and when the Fed will act in response to macroeconomic conditions. Even if the timing and direction of federal funds rate changes could be predicted perfectly, we would still not know for certain how other interest rates would react.

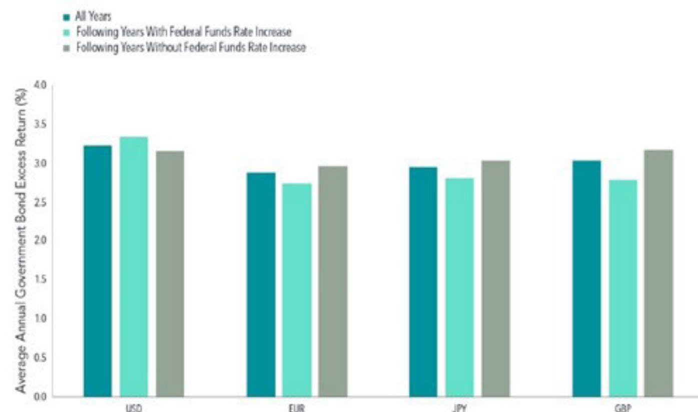
Research by Nobel-winning economist Eugene Fama (2013) finds that any effects of the target federal funds rate on other rates dissipate quickly for longer maturities, and that there is no conclusive evidence on the role of the Fed versus market forces in the long-term path of interest rates.[3] Despite its significant policy role, the Fed is one of many market participants in a larger ecosystem that impacts yield curves at large.

Is Cash Really King?

Using FTSE World Government Bond Index data spanning over 30 years across multiple countries, we examine the relation between the change in the federal funds rate in a given year and the returns on government bond indices in excess of cash over the following year.[4] We find that average annual government bond excess returns were positive and similar in magnitude regardless of changes in the federal funds rate in the past year across all four major currencies **(Exhibit 1)**. Therefore, our analysis does not support the idea of allocating away from bonds to cash in response to changes in the federal funds rate.

Exhibit 1. Positive Excess Return on Average

Average Annual Government Bond Returns in Excess of Cash, 1984–2021



Past performance is not a guarantee of future results.

Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. FTSE fixed income indices © 2022 FTSE Fixed Income LLC. All rights reserved.

Source: USD-hedged returns from FTSE World Government Bond Index data. 1-Month US treasury bill returns from Morningstar. Federal Funds Target Rate spliced from Federal Funds Target Rate (DFEDTAR, Jan 1984–Dec 2008) and Federal Funds Target Range - Upper Limit (DFEDTARU, Dec 2008–Dec 2020) series in FRED database, St. Louis Fed.

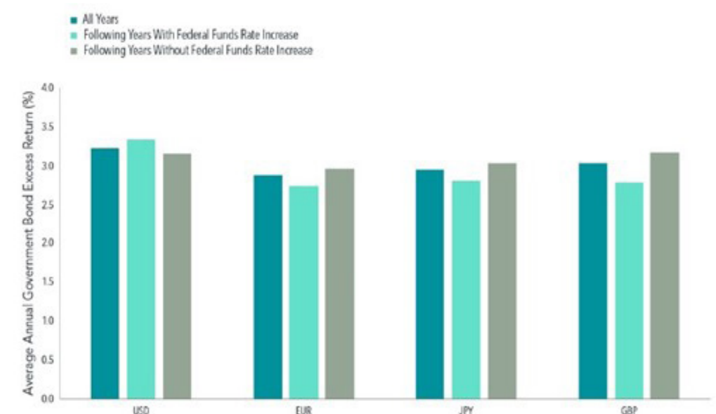
Longer Duration or Shorter Duration?

But does duration matter? Is a shift to shorter-duration bonds a good move if the federal funds rate is expected to increase? To answer that question, we study the relation between past federal funds rate changes and future term premiums. We define the term premium as the return difference between the 7–10 year and 1–3 year government bond index for USD, EUR, JPY, and GBP.[5]

Again, as shown in **Exhibit 2**, we find no reliable relation between past changes in the federal funds rate and future term premiums. We also observe positive term premiums on average regardless of changes in the federal funds rate in the past year across all four major currencies. Therefore, shortening portfolio duration in response to changes in the federal funds rate is unlikely to lead to better investment outcomes, either.

Exhibit 2. Positive Term Premium on Average

Average Annual Global Term Premiums, 1984–2021



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Source: USD-hedged returns from FTSE World Government Bond Index data. 1-Month US treasury bill returns from Morningstar. Federal Funds Target Rate spliced from Federal Funds Target Rate (DFEDTAR, Jan 1984–Dec 2008) and Federal Funds Target Range - Upper Limit (DFEDTARU, Dec 2008–Dec 2020) series in FRED database, St. Louis Fed.

A Systematic Way to Target Term Premiums

If there are no reliable relations between past changes in the federal funds rate and future bond returns or future term premiums, how should investors allocate between cash and bonds, and between longer-duration and shorter-duration bonds? Investors can rely on the information in current term spreads, the yield difference between longer-duration bonds and shorter-duration

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bonds. Research shows that current term spreads reliably forecast future term premiums.[6] A systematic strategy that dynamically varies its duration and currency allocation based on current term spreads across yield curves is a robust way to target higher expected returns in fixed income.

—Dimensional Fund Advisors

1. Based on the US Consumer Price Index for All Urban Consumers (CPI-U, not seasonally adjusted) from the Bureau of Labor Statistics.

2. Jeff Cox, "Fed's Bullard says the central bank's 'credibility is on the line,' needs to 'front-load' rate hikes," CNBC.com, February 14, 2022.

3. Eugene F. Fama, "Does the Fed control interest rates?" The Review of Asset Pricing Studies 3.2 (2013): 180–199.

4. Return on cash is defined as the return on 1-month US Treasury bill. We use US, German, Japanese, and UK WGBI index returns as government bond returns for USD, EUR, JPY, and GBP, respectively.

5. For EUR term premium calculation, we used German WGBI 1–3 year and 7–10 year index returns.

6. Please see the following papers on the relation between current term spread and future term premium:

Eugene F. Fama, "The information in the Term Structure," Journal of Financial Economics 13.4 (1984): 509–528.

Eugene F. Fama and Robert R. Bliss, "The information in Long-Maturity Forward Rates," American Economic Review 77.4 (1987): 680–692.

John H. Cochrane and Monika Piazzesi, "Bond Risk Premia," American Economic Review 95.1 (2005): 138–160.

Investment products: • Not FDIC Insured • Not Bank Guaranteed • May Lose Value

Source: All Eyes On The Fed? A Look At Federal Funds Rate, Bond Return and Term Premium by Mingzhe Yi, PhD, Dimensional Fund Advisors, March 15, 2022.

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