Balancing Your Fixed Income Decisions

By Bryan Harris, Senior Editor, DFA

Fixed income can play an important role in a portfolio. But its role may vary according to an investor's financial needs and concerns. For example, many investors look to fixed income for safety, income, and more stability in their portfolios. They must weigh these priorities against their concerns over future interest rates, inflation, government debt, and other factors that might affect fixed income returns.

Striking this balance can be a challenge in any market environment, but especially now, as low interest rates have sent many investors on a quest for higher-yield bonds or alternative investments. Depending on your approach, this pursuit of yield may invite more risk—some of which may be hard to see or understand.[1]

So, what's an investor to do? How can you make prudent fixed income decisions while also addressing today's low interest rates? Consider these principles:

Remember How Markets Work

The same core investment principles apply in any market environment. One key principle is that in a well-functioning capital market, securities prices reflect all available information. Today's bond values reflect everything the market knows about current economic conditions, growth expectations, inflation, Fed monetary policy, and the like. So, according to this principle, the possibility of rising interest rates is already factored into fixed income prices.

This is one reason investors should view future interest rate movements as unpredictable. Even the market experts who have access to vast amounts of research have a hard time predicting the direction of interest rates. For instance, despite regular predictions of rising interest rates over the past two years, nominal yields on US Treasuries and longer-term bonds have continued falling and now are at historic lows.

Rather than trying to predict macroeconomic forces that are difficult to foresee, investors can look to the market to set prices and focus on the variables within their control.

Start with a Clearly Defined Goal

Fixed income choices should follow a broader investment strategy that defines the role of fixed income in a portfolio. The portfolio can then be customized to meet those specific goals while managing tradeoffs.

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The chart below illustrates how portfolio objectives can influence a fixed income approach. An investor who wants to seek to avoid losing market value might have a different fixed income allocation from someone who wants to take a balanced approach, needs immediate income, or is seeking higher returns. Investors with different objectives typically have different tradeoffs regarding risk, expected return, and costs.

Investment Objective Helps Determine Fixed Income's Role in a Portfolio

OBJECTIVE	ROLE OF FIXED INCOME
Avoid losing money	Capital preservation
Keep portfolio in balance	Volatility customization
Meet income needs	Liability management
Seek higher returns	Total return

For illustration purposes only

Know What You Own

Strive for transparency in a portfolio. This means understanding an investment manager's basic strategy and knowing how the instruments held in the portfolio might respond in different economic, market, and interest rate scenarios.

Unfortunately, investors who chase performance often make their investment decisions based on the past performance and perceived popularity of the strategy. For example, some of the mutual fund categories experiencing the heaviest inflows of cash in the industry are in asset groups that have recently experienced higher than average yields. Higher yields are typically accompanied by higher risks. But do investors know what risks their managers are taking to deliver those attractive yields?

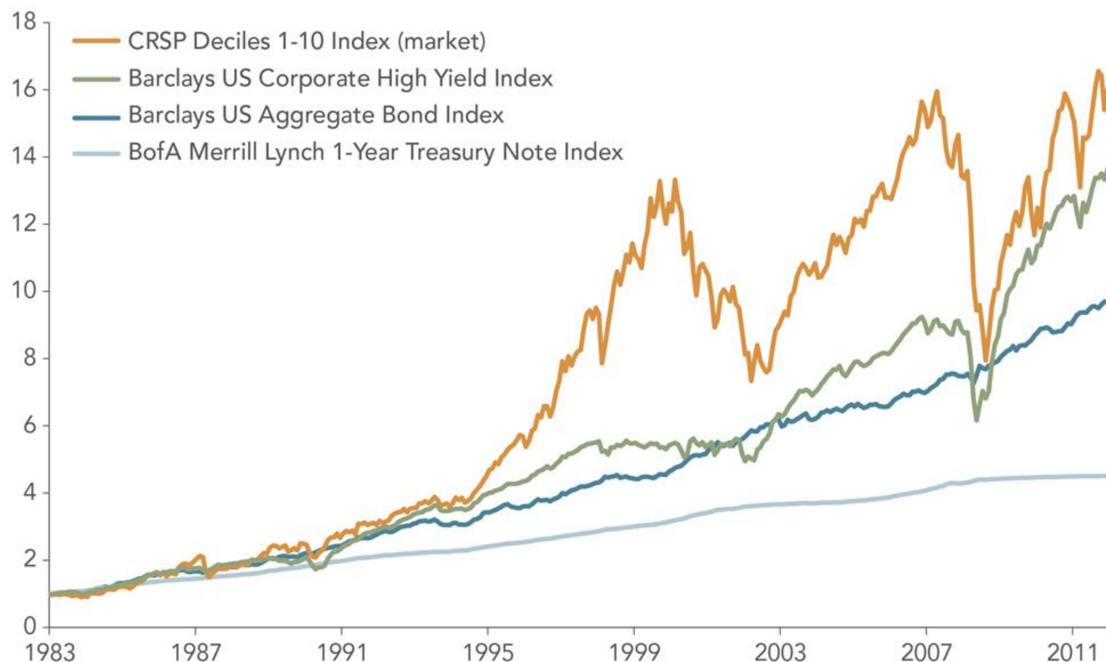
Understand the Tradeoffs

When reaching for higher yield, investors should carefully consider the potential effects of their decisions on expected portfolio performance and risk. In the fixed income arena, investors have two primary ways to increase expected yield and returns on bonds. They can:

- Extend the overall maturity of their bond portfolio (take more term risk).
- Hold bonds of lower credit quality (take more credit risk).

These may be reasonable actions. But pursuing higher income means accepting more risk, as measured by interest rate movements, price volatility, or greater odds of losing value if the issuer defaults.

As shown in the graph below, higher yield can also bring potentially higher volatility. Note that high-yield bonds (as represented by the Barclays US Corporate High Yield Index) have exhibited more volatility relative to other bonds.



Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Barclays data provided by Barclays Bank PLC. CRSP data provided by the Center for Research in Security Prices, University of Chicago. BofA Merrill Lynch Indices are used with permission; copyright 2012 Merrill Lynch, Pierce, Fenner & SmithIncorporated; all rights reserved. Merrill Lynch, Pierce, Fenner & Smith Incorporated is a wholly owned subsidiary of Bank of America Corporation.[2]

Pay Attention to Costs

Investors typically do not realize that investment-related costs determine a large part of a portfolio's yield and return. This applies especially to fixed income securities. In fact, research has shown that a bond mutual fund's expense ratio helps explain much of its net performance—and funds with the highest expenses tended to have the lowest performance within their peer group.[3]

Consider a Global Fixed Income Strategy

Investors have other tools to enhance risk and expected returns in fixed income. You can expand your opportunity set by moving beyond your domestic fixed income market to access yield curves in other country markets. By owning bonds issued by governments and companies from around the world, investors can enhance diversification in their fixed income portfolios. After hedging against currency risk, bond markets around the world have only modest correlations. (Correlation refers to how similarly two investments perform in the same period.) As a result, a global hedged portfolio should exhibit lower volatility than a single-country portfolio or a global portfolio that does not hedge currency risk, and offer the opportunity to take advantage of more attractive yield curves abroad.

Summary

No one really knows when and by how much interest rates will change. Many market pundits have forecasted an upward move for several years now. Investors looking for higher bond yields should understand the higher risks tied to their decisions. Most investors might be best-served by building a fixed income strategy to complement their broader portfolio objectives, understanding the sources of risk and expected return, paying attention to fees, and looking beyond their own country to capture yields in other countries' markets.

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Investing risks include loss of principal and fluctuating value. Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks including changes in credit quality, liquidity, prepayments, and other factors.

Endnotes

1. When interest rates rise, the value of an existing bond declines; when rates fall, existing bond values rise. The market adjusts a bond's price to match the yield available on a new instrument. Investors who hold fixed income securities with longer maturities are exposed to the amplified effects of term risk. A long-term bond is more exposed to rate changes than a short-term instrument, and usually (but not always) offers a higher yield to compensate investors for the extra risk. Also, lower-coupon bonds are more affected by interest rate changes than higher-coupon bonds. For example, if rates move 1%, a bond that pays 3% will experience a greater gain or loss than one paying 5%.

2. CRSP data includes indices of securities in each decile as well as other segments of NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973). The Barclays US Corporate High Yield index measures the performance of fixed-rate, non-investment grade debt. The Barclays US Aggregate Bond Index measures the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market. The BofA Merrill Lynch One-Year Treasury Note Index measures the performance of US Treasury notes. The index is representative of the universe of fixed-rate, non-investment grade debt. Indices are not investment products available for purchase.

3. The study examined monthly alpha and expense ratios for bond funds in the CRSP survivorship-bias-free mutual fund database from January 1992 to December 2011. Source: Dimensional Fund Advisors.