Fixed Income Issues and Portfolio Management

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WHITE PAPERS / JUNE 26, 2013

A rise in interest rates during the month of May led to negative fixed income returns for the period. The experience, along with a continued climb in interest rates in June, have prompted a number of investor questions. How can this happen to my "safe" money? What is in store for interest rates now? Is the bond bull market over? What kind of returns can I expect from my fixed income portfolio? Should I own bonds at all, and, if so, how should they be managed?

The following discussion aims to build a framework to help investors answer these questions.

As you read, bear in mind that the fixed income space has many segments, each with its own unique set of characteristics, challenges, and opportunities. Likewise, each investor's financial situation, investment goals, time horizon and risk tolerance are different. As a result, there is no one-size-fits-all solution to how much fixed income should be allocated to a portfolio or how it should be managed. That being said, the following discussion generally assumes an intermediate to long-term investment horizon of at least five years and an investor with a moderate risk tolerance. To the extent your financial situation is different, you should consult your financial advisor for appropriate adjustments.

Bond Mechanics

A bond's return is a function of two factors: prevailing interest rates at the time of initial investment and interest rates available when periodic coupon payments are received (i.e. the reinvestment rate). In the most basic sense, an investor's return on a bond is the combination of the return streams generated by a series of investments (the original purchase and each subsequent reinvestment of received coupon payments). Provided prevailing interest rates are greater than zero, an investor is always locking in a series of positive returns. Aside from untimely bond trading/liquidation or less common situations such as default or foreign currency bonds, it is not possible to lose money on an investment that simply strings together a series of positive interest rates. This fact alone illustrates a key difference between stocks and bonds, and should start to ease investor concerns in today's volatile market. Furthermore, contrary to popular belief, rising interest rates have a positive, not negative, impact on an investor's return for the life of a bond. To understand why, one must consider the cash flow stream generated by the bond and what happens to these cash flows….and perhaps a bit of bond math. The yield to maturity calculation for a bond assumes no change in interest rates throughout the remaining life of a bond. In other words, all coupon payments are assumed to be reinvested at the same interest rate as the investor's original principal. Importantly, in reality this never actually happens. In a falling interest rate environment, the original yield-to-maturity calculation **overstates** the actual return to the investor as subsequent interest payments are reinvested at lower rates. Falling rates are a negative to

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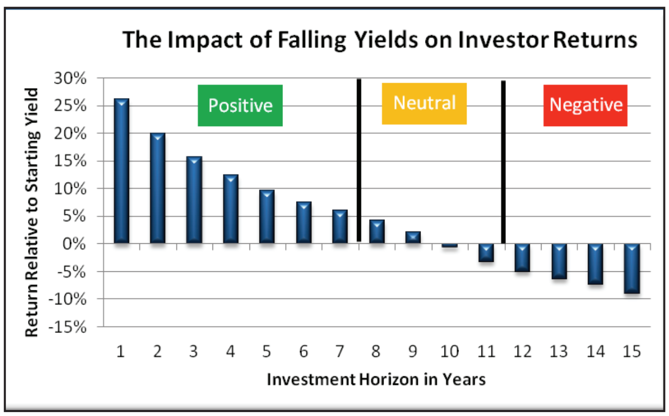
long-term investors. Conversely, in a period of rising interest rates, a bond holder's return will be **in excess** of both starting yields and the original yield-to-maturity calculation. Rising rates are a positive to long-term investors.
In summary, long-term investors should view their fixed income investments as a string of discrete investments, each made at **positive** rates of return. Moreover, rising yields drive higher reinvestment rates which unquestionably generate greater returns for investors.

So why did investor statements reflect bond losses in May and why do so many people fear higher rates? A review of history in the next section helps to answer these questions.

One Man's Bull is Another Man's Bear

Contrary to popular belief, the storied "30 year bond bull market" was only a material advantage to investors with a six or seven year investment horizon, or less. For all others, the impact of falling rates ranged from a neutral to a negative. The following graph helps to illustrate and quantify these points.



Data Source: Bloomberg

The graph represents an analysis of 202 rolling 15 year periods of monthly returns dating back to the peak in interest rates in July of 1981 and ending in May of 2013. The Barclays U.S. Aggregate Bond index was used to represent the fixed income category.

An example may help to understand this somewhat complex graph. An investor starting when yields were 10% would have achieved, on average, a total return of just over 12.5% over the following year. This is represented by the first blue bar in the graph. By the end of the investor's third year, their annualized return was about 11.5%. By their tenth year, the investor's compound annual return was the same as their starting yield, 10%. Finally, provided the investor had been in the market for 15 years, their return would have been an annualized 9% despite their starting yield of 10%. Importantly, the mathematical relationships hold regardless of actual entry point, or starting yield. The 10% example was to simplify the math. Additionally, this phenomenon occurred on a continuous basis. In other words, it applies equally to new money as well as money that had already been invested.

The study resulted in a number of interesting observations:

- During this period of falling yields, an investor had nearly a 70% chance of achieving a first year return in excess of their starting yields. This was the result of the immediate impact on principal value from a decline in rates.

- Within seven years of initial investment, an investor had an equal probability of achieving an annual return either above or below their starting investment yield. This was the powerful, yet delayed, effect of reinvesting interest payments and maturing bonds at lower and lower yields.

- Long-term investors (over ten years) received no benefit from falling yields. As a matter of fact, any current investor that began investing any time prior to April 2001 has faced a **headwind** from falling interest rates.

- Bond returns, over time, are far more impacted by starting yields than movement in interest rates. The favorable experience in bonds over the past 32 years was entirely due to very high starting yields, not declining interest rates.

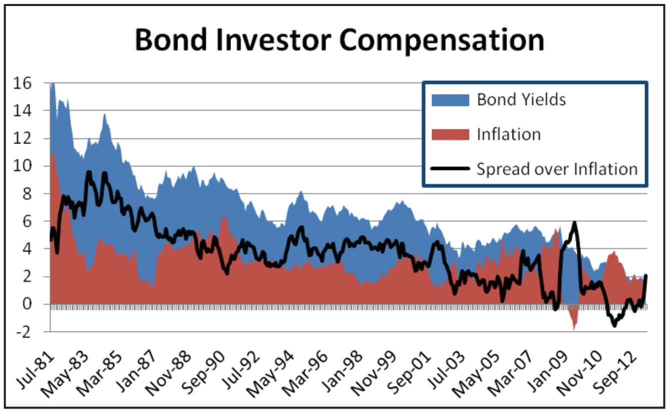
The reasons most people fail to realize these facts are quite simple. The principal gain from a drop in rates is immediate and easily quantifiable. Conversely, the detrimental impact of lower reinvestment rates works through a slower, less transparent, process that is harder to quantify and only observable over time. Indeed, as illustrated by the previous graph, on average it takes a decade for principal gains to be swamped by lower reinvestment rates.

Cause for Optimism

Why the history lesson and what does this have to do with *today's* concern of *rising* rates? The previous three plus decades were defined by high starting yields but disappointing reinvestment rates. The future is likely to be the mirror image. Starting yields are low, but reinvestment rates will probably be higher. Under this scenario, long-term investor returns will be in excess of acquisition yields-to-maturity, greater than current yields, and far from widespread predictions of doom and gloom. Of course, long-term gains will only come following the short-term pain of principal pressure. We have seen the reality of this movement in recent weeks, but it is a necessary evil for expected returns to move higher.

The Return to Normalcy

The only way to achieve more attractive long-term returns on bonds is to run the gauntlet of rising rates. This process must take place in order for investors to be adequately compensated for both risk as well as their sacrifice of current spending for greater future wealth. How far off are we from adequate compensation? In other words, how much do interest rates need to rise to return to normalcy? Considering historical compensation rates is a good starting point.



Data Sources: Bloomberg & U.S. Dep. of Labor

The graph above shows yields for the Barclays U.S. Aggregate Bond Index, in blue, starting in July of 1981 and running through June 20, 2013. Overlaid on top of this data, in red, is the rate of inflation for the same period, as defined by the CPI. The black line illustrates historical spreads of bond yields over inflation. Over the period studied, the average spread of yield over inflation has been 3.3%.

The bad news is in recent years bond yields have failed to even compensate investors for inflation. This is seen by the black line dipping into negative territory, something we have not seen in decades! This is also why bond investors desperately needed a rise in yields. The good news is the process has come a long way – perhaps much further than most people realize or appreciate. As a matter of fact, the recent "pain" of rising rates has taken spreads back to positive territory. Not only that, nearly 40% of the required move back to the long-term average has already taken place.

Expected Fixed Income Returns

There are reasons to believe the future will not be the complete reverse of the past 32 years. At the very least, even the most pessimistic forecasters are not suggesting a return to 15% plus interest rates experienced in the 1980s. Should rates back up to more benign levels, the investment time horizon for higher reinvestment rates to overcome initial principal hits will be shorter than that witnessed when rates were in decline. The current yield on the Barclays U.S. Aggregate Bond Index is just over 2% at present. Under the scenario described, it is reasonable to assume fixed income returns will compound over the next six to seven years at about that rate. The early years will likely be lower, and perhaps even negative at times. The later years will likely be higher. Following this necessary, and desirable, acclimation period, fixed income returns will hopefully stabilize at higher, more consistent levels.

Competitive Investments and the Case for Fixed Income

It has been established that rising rates, when they come, would enhance fixed income returns in time. Yet, the current expectation for return is low. Why invest in fixed income at all and what are the alternatives? Cash is one possible alternative. Cash has less potential for price depreciation, but is currently returning essentially nothing. Under the Federal Reserve's zero interest rate policy, the purchasing power of cash erodes every week, month, and year due to inflation. In short, cash is a wasting asset. Stocks, real estate, and other risky assets are other possibilities. Compared to bonds, the expected returns on these assets are indeed higher. Unfortunately, they also carry a greater likelihood of loss. Moreover, when losses occur in these riskier categories, they can be far more severe than for bonds. The capital markets offer no free lunch. Greater certainty comes at a price of lower returns and the potential for higher returns comes at a price of greater downside risk.

Fixed Income Management in Today's Environment

Mathematic reality dictates that fixed income returns will be low in coming years. At the same time, provided interest rate adjustments are no more swift and violent than they were on the way down, returns will be far from the catastrophic outcomes increasingly touted by the financial press and feared by nervous investors. (Keep in mind, this assumes an intermediate to long-term investment horizon and a moderate risk allocation. Each investor's situation and portfolio are different. Leveraged fixed income investments, long maturity bonds, high levels of credit risk, and concentrated segment exposures could result in different outcomes.)

In many of our fixed income allocations, where appropriate, we have taken the following actions to help mitigate the impact of the current challenges faced by the bond market.

- An investor can, and should, choose a desired level of interest rate sensitivity. For most client portfolios, we have gradually reduced duration over the previous three years. (Duration is a commonly used metric to quantify interest rate sensitivity.)

- The interest rate sensitivity of the overall bond market has increased by about 20% in recent years. An investor that takes either a very broad approach or that utilizes a high allocation to passive investment approaches in fixed income may have unwittingly allowed their interest rate risk to rise. We have taken two key steps in recent years to manage this issue:

    - Passive strategies have been reduced in favor of more active portfolio management.

    - Multi-strategy fixed income managers were added to gain tactical advantages, to achieve more active positioning, and to access a wider subset of fixed income opportunities.

- Credit related fixed income areas, namely high yield bonds, have appreciated substantially over the past year. Prices have been pushed higher by a thirst for yield rather than by strong economic fundamentals. This poses risk to investors. In response, in many cases we have reduced dedicated exposures to speculative fixed income in favor of multi-strategy fixed income managers. These managers have greater latitude to move into and out of speculative fixed income segments than a dedicated high yield manager.

In closing, the fixed income market is currently the source of great investor concern, and rising rates are a prevalent discussion topic. Consideration of the negative impact on bond prices from a rise in rates, however, is only half of the story. Higher rates also enable investors to reinvest interest payments and maturing bonds at higher rates of return. Empirical evidence suggests the initial pain of downward pricing is likely to be overcome by higher reinvestment rates within five to ten years. While the process to get there may be uncomfortable, the transition is necessary for expected fixed income returns to revert back to more appropriate levels. Importantly, nearly 40% of the likely adjustment has already taken place, and the expected cumulative return on fixed income will remain positive, albeit low, during the adjustment period remaining.

Bonds have a place in a portfolio and possess risk/return characteristics unlike any other asset class. Their return streams are also uncorrelated with many other asset classes, which makes them advantageous in portfolio designs. Despite these advantages, investors should take a proactive approach to risk mitigation and return optimization within the fixed income segment of their portfolios. Specifically, interest rate sensitivity should be reduced from historical levels. Furthermore, a heightened emphasis on active portfolio management is recommended, including the use of multi-strategy managers. Lastly, investors should be cautious with their use of speculative grade debt in an economy that is only slowly recovering

Disclaimer

This market commentary was written by Robert W. Lamberti, CFA who serves as Vice President of Investments for Summit Financial Resources, Inc. 4 Campus Drive, Parsippany, NJ 07054. Tel. 973-285-3600, Fax: 973-285-3666. Source of Performance: Morningstar® and Bloomberg. Indices are unmanaged and cannot be invested into directly. The investment and market data contained in this newsletter is not an offer to sell or purchase any security or commodity. The Barclays U.S. Aggregate Bond Index is a market capitalization-weighted index comprising Treasury securities, Government agency bond, Mortgage-backed bonds, Corporate bonds, and some foreign bonds traded in the U.S. Investment grade bond analysis included bonds with ratings of

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