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Portfolio Insights

Understanding Fixed Income

A fundamental element of the fixed income markets is the inverse relationship that exists between market interest rates and underlying bond values. Investors participating in the fixed income markets must address a unique set of risk considerations; including the possibility that bond values could be expected to fall in a rising interest rate environment.

Interest rates have generally been moving lower for decades. The mid-double digit interest rates of the 1970's rewarded savers and caused borrowers to take pause. As interest rates have systematically moved lower over the last several decades there has been a shift from saving toward borrowing. Although borrowing at low interest rates may facilitate economic growth (good for equities), those same low rates end up punishing those desiring to save/invest with a more conservative posture.

At the core of a bond is a loan. When an investor invests in a bond, either directly or through a fund structure, they are lending money to the bond's issuer who promises to pay the investor back the principal (or par value) when the loan is due (on the bond's maturity date). In the meantime, the issuer also promises to pay periodic interest payments to the bond holder to compensate the investor for the use of their money. The interest rate paid by the issuer is known as the bond's stated interest rate or coupon rate, and is generally fixed at the issuance of the bond. When new bonds are issued, they typically carry coupon rates at or close to the prevailing market interest rate.

Bonds characteristically have a lower expected return than stocks over time given their relative position in the capital structure. In other words, a bond issuer is required to pay bond holders before the common stock shareholders. The expected lower rate of return also tends to mean the bond can have a lower level of expected volatility and lower risk characteristics than their stock counterpart.

Bonds, as an asset class, are an important component to a well balanced portfolio strategy. Because they often have low correlation characteristics to equity investments, they represent an important

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opportunity to diversify a portfolio and manage a portfolio's volatility profile over time. Bonds possess unique risks and investors need to manage many critical factors when building an effective bond portfolio, or a bond component to a balanced portfolio.

Primary among these considerations is credit default risk, which reflects the issuer's ability to repay the loan over time, i.e. their credit worthiness or credit quality. A higher level of credit quality is associated with higher confidence in the ability of the issuer to repay the loan, thereby resulting in lower borrowing costs. While occasionally there may be various price dislocations between issuers regarding the level of interest being paid, issuers with higher credit ratings generally can borrow at lower interest rates.

Another is interest rate risk, which is defined as the risk that an investment's value could change due to movement in prevailing market rates, the spread between certain rates, the shape of the yield curve, or various other interest rate relationships. As noted above, the relationship is generally inverse – meaning as market interest rates move up a previously issued bond's price will move down. Conversely, if current rates move down, the value of existing bonds could move higher.

This inverse relationship is mathematical and can be illustrated below.

An investment of $100,000 in a 10 year bond with a fixed rate of 4.0% interest will result in the investor receiving $4,000 per year of interest for 10 years and in the end receive the $100,000 principal returned. For this example, we will assume the bond to have no default risk, no call provisions, no conversion features, and no original issue discount, etc. Accordingly, the investor will receive a total of $140,000 over the 10 year period for the original $100,000 investment if the investor holds the bond to maturity.

However, there are important dynamics occurring over the life of the bond and not all investors hold bonds to maturity. Foremost among these dynamics will be the movement of market interest rates over the life of the bond and how these movements impact the market value of the bond.

Market interest rates change over time based on numerous factors; including policy setting, supply & demand, and relative value with respect to alternative investments to name a few. As market factors change and market interest rates move up or down in relation to previously issued fixed rate bonds, the value of these bonds will change to maintain what is known as "equilibrium" in the market.

Returning to our illustration, if current rates have risen to 5%, the original 4% bond in our example will decline in value. Logically, the market will no longer offer $100,000 for the 4% bond when new bonds having a 5% rate of interest are available.

The decline in value on the 4% bond in our example would be determined mathematically so that the buyer of this 4% bond would enjoy a yield to maturity that was equivalent to the current rate of 5%. Purchasing the 4% bond at a discount would make the buyer indifferent between the two choices, default risk aside.

Bond portfolios have an important metric known as effective duration, which is simply a measure of the portfolio's sensitivity to changes in current interest rates and calculated based on expected cash flows. The higher the effective duration calculation, the greater the anticipated value fluctuations of the portfolio will be as rates move up or down. In other words, the higher the duration, the more the portfolio's value would fall if there is a rise in interest rates. Normally, if current interest rates change by 1% point, a fixed income security's price is likely to experience an inverse change by approximately 1% point for each year of duration.

Bond investing is a complex process and interest rate risk is an important concern if our economy is at an inflection point wherein rates are moving higher. In addition to proper diversification and credit risk factors, investors must carefully monitor the effective duration of their fixed income investments and take steps to limit interest rate exposure.

Given we are at an inflection point with interest rates moving higher, we currently favor an unconstrained fixed income strategy which provides increased flexibility to generate returns and manage risk. In practice, an unconstrained fixed income strategy seeks to untether portfolio strategy decisions from a traditional fixed income benchmark. In this approach, investment strategy is designed to provide exposure to the desirable characteristics of fixed income (diversification and risk reduction), while avoiding the undesirable (segments of the market with overvalued securities and unattractive risk/reward tradeoffs). Unconstrained income strategies allow access to a wider opportunity set for total returns in fixed income. In today's markets, opportunities for bond investors evolve rapidly and may not necessarily be reflected in traditional market benchmarks.

Today, traditional fixed income benchmarks combine historically low yields and extended duration. With rates near generational lows, this current trade-off leaves traditional fixed income exposures vulnerable on a total return basis. In short, the margin for error in interest rate risk remains very low.

While investors have traditionally used fixed income in their asset allocation strategies to offset equity risk and as a source of income that is intended to stabilize overall portfolio returns, in the current environment traditional fixed income allocations could leave investors exposed to substantially greater total portfolio risk.

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Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value

The two main risks related to fixed-income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments.

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