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The Role of Fixed Income

Overview: For many investors, fixed income (or bonds) is an important part of their investing equation. However, many investors misunderstand the roles that fixed income play in portfolios. The following discusses the proper use of fixed income.

One of the most basic distinctions in investing is between equity and fixed income. While many investors know the difference between the two, it's important to note the differing roles they play:

- σ Equity is for wealth appreciation.
- σ Fixed income is for wealth preservation.

This is a simple, yet important distinction that ends up defining the purchases investors make with respect to each asset class.

Historically, equity has had higher returns than bonds, but has also been associated with much higher risk. Thus, those seeking capital appreciation (or higher returns) tilt their portfolios more heavily toward stocks, as they have higher expected returns. However, a portfolio consisting entirely of stocks may not be appropriate for some investors for many reasons:

- σ They may not have the ability, willingness or need to take such risk.
- σ They may be seeking a stable source of income.
- σ They may have a need for cash in the near future and must have ready access to their capital.
- σ They may have a shorter time horizon.

This is where fixed income has a role. There are three main uses for fixed income:

- σ It is used to mitigate the risk of a portfolio and stabilize the portfolio.
- σ It provides a liquid source of capital should investors need it.
- σ It provides a steady income stream.

Mitigating Risk

As stated earlier, equity has higher expected returns due to the higher risk involved with investing in the asset class. On the other hand, fixed income offers more stable expected returns. The price for this stability is lower expected returns.

For investors who do not want the risk of an all-equity portfolio, adding an allocation to fixed income helps dampen that risk. Generally speaking, portfolios with a higher allocation to fixed income experience less volatility than those tilted more heavily to equities.

Providing Liquidity

Oftentimes, investors have specific short-term needs (such as paying taxes) or unexpected expenses and must have immediate access to their capital, thus needing it to be liquid. A defined maturity structure helps ensure funds will be available when those needs arise. The fixed income portion of their portfolios can be structured and tailored to meet both unforeseen liability needs and those that are planned. This can be done by shortening the maturities of high-quality bonds and purchasing bonds that meet specific dates when the money will be needed. In the former case, such bonds can be easily sold with minimal market impact.

Providing a Steady Income Stream

Creating a structured laddered portfolio of high-quality fixed income securities minimizes reinvestment risk, which is the risk of reinvesting money from maturing bonds into securities with lower interest rates. Building a portfolio with small portions maturing in any given year helps address reinvestment risk, thus keeping the income stream steadier.

What to Consider for a Bond Portfolio

Because the overall goal of the fixed income portion of a portfolio is stability, the fixed income instruments chosen should be of the highest quality. This means selecting fixed income instruments with the highest probability of accomplishing their intended goal.

Credit quality is one of the first considerations. The lower the credit quality of a bond, the more likely the issuer is to default. Obviously, the higher the likelihood of default, the less stability in the portfolio, which defeats the purpose of adding an allocation to fixed income in the first place.

It's true that securities further down the grade scale provide higher expected returns. However, there are several issues with investing in high-yield (or junk) bonds. Higher expected returns mean higher risk, certainly the case for junk bonds.

Furthermore, such bonds have a higher correlation to equities, meaning they act more like equities and add volatility to the portfolio. For prudent investors, the goal of the fixed income portion of the portfolio is to dampen its overall risk, not increase it.

In addition, numerous studies have shown that investors have not been appropriately compensated for the additional risk of junk bonds. A 2004 study in the *Journal of Portfolio Management* showed that seven- to 10-year high-yield bonds not only lagged the returns of Treasury bonds, AAA/AA bonds and A/BBB bonds, but did so with higher volatility.¹

Has Credit Risk Been Rewarded?		
Asset Class	Mean Return (%)	Standard Deviation (%)
7-10 Year Treasury Bonds	9.6	6.5
7-10 Year AAA/AA Bonds	9.6	5.7
7-10 Year A/BBB Bonds	9.6	5.3
7-10 Year High-Yield Bonds	8.8	7.7

Source: *Journal of Portfolio Management*

For those seeking higher expected returns, it would be more appropriate to tilt their portfolios more heavily toward equities (or their equity portions to riskier asset classes) than to tilt their fixed income component toward riskier bonds.

Much like junk bonds, longer-term bonds also exhibit higher volatility and higher correlation with equities than shorter-term bonds. Investors considering longer-term bonds need to ask themselves why they want to add these securities to their portfolios, and if other more tax-efficient means of taking increased risk may be more appropriate.

Differences Among Types of Bonds

It should be noted that not all highly rated bonds are created equal. First, those that have a high rating due to insurance still carry more risk than may be appropriate. Keep in mind that the insurance is only as good as the company that issues it.

In 2008, the credit quality of most insurers came into question. If those insurers suffer a downgrade as most have, then the insured credit quality will fall as well, meaning the underlying rating of the bond comes into play. This is why it is important to consider the underlying rating of the bond as well as the sector.

Ratings also mean different things across types of bonds. For example, a AAA-rated municipal bond is not the same as a AAA-rated corporate bond. According to Moody's, for the period 1970–2006 municipal bonds rated Baa (or the lowest rung of investment grade bonds) by Moody's were four times less likely to default than corporate bonds rated AAA (or the highest possible grade).² This must be taken into account when building bond portfolios.

Another key difference is the recovery rates of bonds that default. Another study by Moody's for the period 1970–2000 found that investors recovered 66 percent of their municipal bonds' value when they defaulted, compared with 42 percent for corporate bonds.³ When Orange County, Calif. defaulted in 1994 (which is the largest municipal bond default in U.S. history), investors eventually received 100 percent of their principal and interest.⁴

Even within the municipal bond category, some bonds have historically been safer than others. For example, health care and industrial development bonds have historically been much riskier than general obligation and essential services bonds. Historical default rate studies support this notion that sector selection and screening is important in the selection of municipal bonds.

Summary

For many investors, fixed income plays an essential role in their portfolio. Thus, it is important to understand the proper way to use fixed income instruments in the portfolio to give it the highest chance of success. This disciplined approach to the building of fixed income portfolios has been no more evident than over the past two years. High-yield bond funds were down almost as much as equities, which gives testimony to the efficacy and prudence of keeping the credit quality high.

¹ Antti Ilmanen, Rory Byrne, Heinz Gunasekera and Robert Minikin, **Which Risks Have Been Best Rewarded?** *Journal of Portfolio Management*, Winter 2004.

² **The U.S. Municipal Bond Rating Scale.** *Moody's*, March 2007.

³ **How Safe Are Municipal Bonds Against Default?** *Piper Jaffray*, 2005.

⁴ **Moody's U.S. Municipal Bond Rating Scale.** *Moody's*, November 2002.

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