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Beyond the core: Reassessing fixed income portfolios amid rising interest rates

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Originally published on fsinvestments.com

Recent data paints a bleak outlook for "core" fixed income. But there's a broad opportunity beyond it that may help investors generate an attractive level of income and higher total returns while managing interest rate risk.

The U.S. 10-year Treasury yield recently breached the 3% mark and is currently sitting at multi-year highs. At around 3.15%, the yield remains low by historical standards, but the recent rise should give investors pause.[1] With interest rates still well below their long-term average, now might be a good time for investors to reassess the risks of a traditional fixed income portfolio.

Traditional fixed income portfolio yields' recent fall

Amid a three-decade bull market for bonds, fixed income investors could generally rely on a "core bond" strategy to meet their dual objectives of generating income and preserving capital. Benchmarked to the Bloomberg Barclays U.S. Aggregate Bond Index (Barclays Agg), a traditional fixed income portfolio typically included a mix of Treasuries, municipal bonds, investment grade corporate bonds and mortgage-backed securities.

Between 1983 and 2012, these types of investments produced relatively strong performance. Over the past five years, however, traditional fixed income investments have not delivered the same levels of income and returns. Whereas the Barclays Agg had an average yield of 6.6% and generated an annualized return of 8.1% between 1983 and 2012, over the past five years the index yielded only 2.4% on average and generated an annualized return of just 1.6%.[2]

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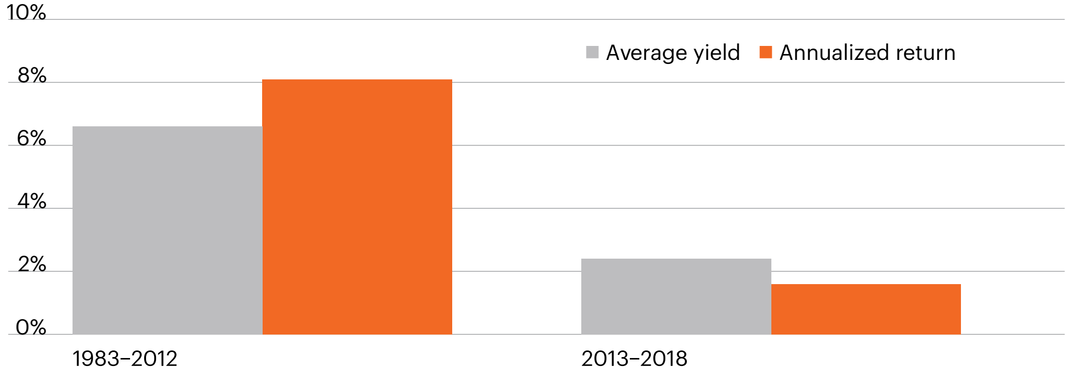
CORE FIXED INCOME HAS BEEN CHALLENGED IN RECENT YEARS[2]



Why duration matters when interest rates rise

While traditional fixed income investments typically carry little in the way of credit risk and are generally perceived as safe investments, their performance can suffer during times of changing interest rates. Duration is the most common metric used to gauge a bond's sensitivity to changes in rates. The higher a bond's duration, the higher its sensitivity to changing interest rates.

The duration of a traditional fixed income portfolio has been on the rise for over a decade.[3] At six years, the Barclays Agg's effective duration is almost double what it was a decade ago.[3] This relatively high sensitivity to rising interest rates, combined with the benchmark's relatively low yield, has resulted in significantly more modest returns for investors' core bond allocations over the past five years.

Given the potential for securities that typically make up a core bond strategy to decline in value if interest rates rise, investors should be especially alert to this type of risk given today's market environment. As the yield on the U.S. 10-year Treasury note rose from 2.4% to 3.1% through the first nine months of 2018, the Barclays Agg has generally underperformed, returning -1.6%.[3]

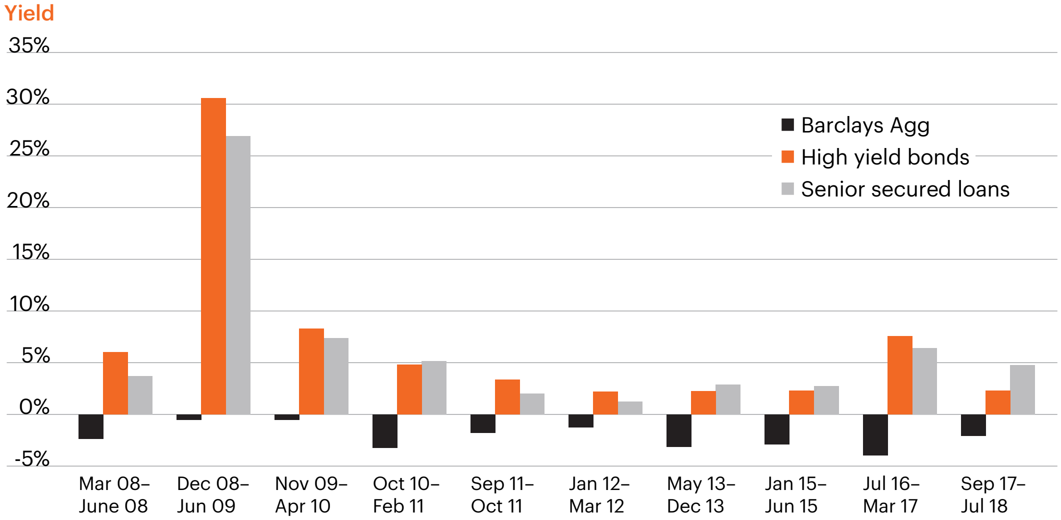
Income opportunities in today's market

So, where can fixed income investors turn? There is a broad $6.5 trillion opportunity beyond the core fixed income opportunity set that may help generate an attractive level of income and higher total returns while helping manage interest rate risk.[4]

Fixed income sectors such as high yield bonds, emerging market debt and senior secured loans may serve to complement a traditional core fixed income portfolio. Allocating to these sectors may help diversify a traditional bond portfolio and provide differentiated sources of income.

Higher Treasury yields often coincide with periods of economic expansion, rising corporate earnings and generally stable company fundamentals — environments supportive of lower-duration, credit-sensitive investments. As the chart shows, high yield bonds and senior secured loans have typically outperformed the Barclays Agg during periods of rising rates.

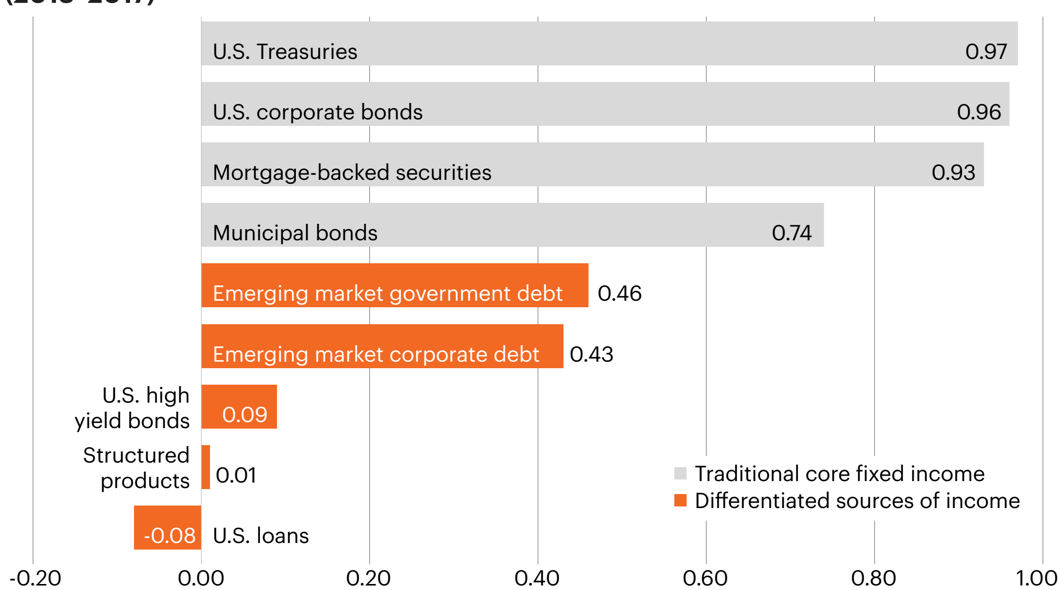
HY BONDS AND SENIOR SECURED LOANS HAVE TYPICALLY OUTPERFORMED BARCLAYS AGG IN RISING RATE ENVIRONMENTS



Source: Bloomberg. High yield bonds represented by ICE BofAML U.S. High Yield Index. Senior secured loans represented by S&P/LSTA Leveraged Loan Index. ICE BofAML U.S. High Yield Index is designed to track the performance of U.S. dollar-denominated below investment grade corporate debt publically issued in the U.S. domestic market. S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market.

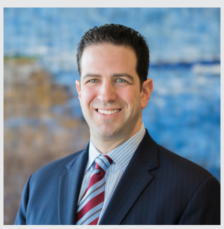
Notably, the recent move in the U.S. 10-year Treasury note has produced a similar dynamic. High yield bonds and senior secured loans have both generated positive returns through the first part of 2018 due, in large part, to their generally low durations, higher coupons and negative correlation to U.S. Treasuries.[5,6]

CORRELATION TO THE BLOOMBERG BARCLAYS U.S. AGGREGATE BOND INDEX (2013–2017)



Source: Bloomberg. As of December 31, 2017. U.S. Treasuries are represented by the ICE BofAML U.S. Treasury Index. U.S. corporate bonds are represented by the ICE BofAML U.S. Corporate Master Index. Mortgage-backed securities are represented by the ICE BofAML U.S. Fixed Rate CMBS Index. Municipal bonds are represented by the ICE BofAML U.S. Municipal Securities Index. Emerging market government debt is represented by the JPMorgan EMBI Global Index. Emerging market corporate debt is represented by the JPMorgan CEMBI Broad Index. U.S. high yield bonds are represented by the ICE BofAML U.S. High Yield Index. Structured products are represented by the JPMorgan CLOIE Index and Clarity Solutions Group, LLC. U.S. loans are represented by the S&P/LSTA Leveraged Loan Index. Diversification does not protect an investor from market risk and does not ensure a profit. The benchmarks are shown for illustrative purposes only. An investment cannot be made directly in an index.

If history is any guide, investments with lower durations, such as high yield bonds and senior secured loans, may help provide income and manage volatility should U.S. Treasury yields continue to rise from current levels. As a result, a prudent approach may be diversifying a fixed income portfolio to include investments with higher yields and lower correlations to the Barclays Agg.



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As Executive Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries—as well as their potential impact on investors. His nearly two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources.

1 Federal Reserve Bank of St. Louis, as of October 11, 2018, https://bit.ly/29ecBfp.
2 Period shown for the last 5 years is December 31, 2012 to June 30, 2018. Period shown for prior 30 years is from December 31, 1982 to December 31, 2012. A core fixed income portfolio is represented by the Bloomberg Barclays U.S. Aggregate Bond Index. Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). The index is shown for illustrative purposes only. An investment cannot be made directly in an index.
3 Bloomberg, based on the duration of the Bloomberg Barclays U.S. Aggregate Bond Index, as of October 11, 2018.
4 Differentiated sources of income refers to non-core fixed income investments (including, but not limited to, emerging market government debt, high yield bonds, emerging market corporate debt and structured products). The yield of these investments may be higher than those of core fixed income investments (including, but not limited to, U.S. Treasuries, investment grade corporate bonds and U.S. municipal bonds). Investing in non-core asset classes may carry increased risks as compared to core fixed income assets, including credit risk and liquidity risk.
5 ICE BofAML U.S. High Yield Master II Index.
6 S&P/LSTA Leveraged Loan Index.