

Fixed income functions

Five selling points



CHAPTER 2

From income to stability, fixed income is fulfilling a number of functions in portfolios today, as we found out from five professional investors.

Jennifer Hill



YIELD

With yields around 2% over inflation, Cetera Investment Management in El Segundo, California, is an 'aggressive buyer' of fixed income.

'We feel yields are at or near their cycle high and the volatility in them is just market participants grappling with uncertainty,' says chief investment officer Gene Goldman.

The firm has been raising duration on the basis that yields will decline. Higher yields are doing the Fed's work by tightening financial conditions and leading to increased borrowing costs.

On the macroeconomic front, the economy is showing signs of a slowdown and Fed speak consistently suggests a pause in interest rates hikes. Furthermore, the Fed's unofficial third mandate is to moderate long-term interest rates. If yields continue to rise, the Fed could jump in as a buyer.



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Gene Goldman, CIO
Cetera Investment Management

Demand is also coming from institutions, especially insurance companies with a need for asset-liability matching, attracted by current yield levels. Simultaneously, supply could be on the wane with Treasury guidance that recent increases in issuance will not continue as long as the market anticipates.

Cetera's top recommendation is the John Hancock Bond fund, which has around half of its assets in government and agency debt. It is cautious on high yield debt given narrow spreads due to a lack of issuance and extreme optimism that the economy will avoid a recession.

'While a near-term recession is less likely given the strong third-quarter GDP print and ensuing momentum into the fourth quarter, high yield spreads are giving a near-zero chance of a recession,' says Goldman.



RETIREMENT INCOME

Henrickson Nauta Wealth Advisors in Belmont, Michigan, tailors exposure to the life stage of the client. A key fixed income function for older clients is the provision of retirement income.

'If the client needs an income stream, especially during retirement ages, we prefer a steady yield,' says wealth advisor Olga Hejl.

'That doesn't mean that we are willing to sacrifice the quality or duration of bonds to provide this income stream. Higher quality bonds with shorter duration are typical in our clients' portfolios but we utilize other asset classes, such as alternatives, to provide additional yield and reduce overall portfolio risk.'

In the early part of 2022, the firm shifted some fixed income exposure into multi-year guarantee annuities. This gave a source of positive performance and helped clients to weather the deep decline in equities and bonds.

At present, a typical retirement client has 15-20% in bonds. This is primarily allocated to short duration investment grade bond funds and individual bonds, sitting alongside a smaller allocation to inflation-protected bonds.



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Henrickson Nauta Wealth Advisors

'We're also starting to look at the new and upcoming type of mutual funds that guarantee an income stream depending on the age of the client,' adds Hejl. 'This might be a great source of higher yield for some clients while having the flexibility of a mutual fund structure.'

Its clients in the accumulation stage are less likely to be invested in bonds unless they have a very low risk tolerance. Even then, the advisor prefers other asset classes.



STABILITY

Julex-OCIO always uses fixed income as a stabilizer in client portfolios – a tool that offsets or mitigates the risk it assumes when allocating to equities and alternatives, such as venture capital and private equity.

'Fixed income for us is about stability,' says Rob Brown, chief investment strategist of the Wellesley, Massachusetts-based firm. 'We view the income generated by fixed income as de minimis except in highly specialized situations such as when a client requires a buy-and-hold bond ladder.'



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Julex-OCIO

In March 2020, when the yield on 10-year US treasuries fell below 0.5%, it had virtually no allocation to fixed income, having replaced it with real estate and other alternatives such as option-protected equities and physical reinsurance.

Today, with yields having returned to a 'relatively attractive and sustainable level', the typical client has a 40% allocation comprised predominantly of US treasuries and biased towards shorter maturities.

'Our general preference is for a five-year average duration and an average AA+ credit quality,' says Brown.

As recession looms, he believes most other parts of the credit spectrum are best avoided though there may be pockets of opportunity.

'Some credits have potentially been oversold, for example in the commercial real estate sector which we allocate to opportunistically.'

Looking ahead, he foresees a turbulent road for bonds as the economy waxes and wanes. He expects the yield to maturity to fall between today and the bottom of the coming recession then subsequently rise for 15-20 years as governments borrow to fund their rapidly growing budgets.



BALLAST

For Cherry Tree Wealth Management in Minnetonka, Minnesota, fixed income provides portfolio ballast. Chief investment officer John O'Connor views last year's simultaneous sell-off in bonds and equities as 'a once in a career moment'.

'It doesn't change how I view fixed income,' he says. 'We invest in fixed income first and foremost for stability. Today that comes with yield, but that's not why we invest in bonds. It's the "sleep well at night, don't worry about me" part of the portfolio.'

'When stocks fall, investment grade bonds can be counted on to hold value or appreciate. That's priceless when you're in withdrawal mode or you want cash to buy stocks on sale.'



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Cherry Tree Wealth Management

Cherry Tree almost exclusively invests in investment grade corporate and government bonds, which have 'nice' yields of 5.5% or more. O'Connor sees no need to take on more credit risk to reach for yield.

'Our average maturity is around four years because our math says you don't get paid enough to own long-term bonds,' he continues.

To achieve this, the firm uses a combination of short-term and intermediate-term bond index funds. It also allocates to funds that target sweet spots in the yield curve without relying on portfolio managers to predict future rates.

Lately, it started using target maturity ETFs, which hold the same bonds as the other index funds but allow clients to know what they will earn from now until maturity. 'I'm willing to bet we use more of these in the future,' adds O'Connor.



DIVERSIFICATION

Innovest Portfolio Solutions uses fixed income as a diversifier – to offer stability and income during market volatility. It also recognises its ability to provide resilience to overall asset allocation.

Austin Cleveland, an analyst assistant at the Denver, Colorado-based firm, reckons fixed income is more attractive today as a diversifier than any point during the last decade given the higher yields that bonds currently offer. In fact, at the time of writing 10-year real yields had reached levels not seen since 2007 as measured by the St Louis Federal Reserve.



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Austin Cleveland, analyst assistant
Innovest Portfolio Solutions

'Last year, returns suffered from a high correlation between stocks and bonds. Today, thanks to a higher base rate, interest rate risk is lower,' says Cleveland. 'The impact of further rate hikes is less detrimental to future returns when compared to lifting rates from the zero bound.'

'In addition, by their very nature and place in the capital structure bonds compensate investors for bearing risk differently than other assets like equities.'

At present, the firm is particularly attracted to investment grade corporate bonds on the basis that they can offset risk assumed in growth areas of portfolios on a go-forward basis.

'Given the current tightness of credit spreads, where yields are pricing a low probability of recession, we do not find high yield to be an attractive sector and instead lean towards higher quality issues,' adds Cleveland.

'AA-rated bonds offer yields comparable to grade B bonds from a decade ago, which in our opinion amplifies the appeal of high-quality issuances.'



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