Fixed Income Strategies

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Research indicates that the bond market is efficient and value cannot be added to a fixed income portfolio through interest rate forecasting or security selection. Research also indicates that current interest rates are the best predictor of future rates. It is my experience that investors in fixed income securities are more sensitive to absolute risk (the volatility of returns and downside risk) than they are to relative risk (how well they perform relative to a bond index).

For these reasons, I believe fixed income investments should be limited to high quality securities with maturities of five years or less and a “variable maturity” strategy should be implemented for most investors. A variable maturity strategy uses the current yield curve to calculate expected returns and optimal maturities and holding periods for bonds in the portfolio, and is superior to bond indexing or “laddering” strategies. A low cost, institutional-level bond fund is the most cost-efficient way to implement a variable maturity bond strategy.

The Role of Fixed Income in a Portfolio

The primary role of fixed income in a long-term, growth-oriented portfolio is to reduce portfolio volatility. Investors seeking an appropriate risk/return balance for their portfolio should consider introducing fixed income securities to their asset mix once the stock portion of a portfolio has been diversified in a way that eliminates all “uncompensated” risk (that which is normally introduced by active management).

With stocks, this is best achieved using index funds or passively managed asset class funds. Another role of fixed-income securities in a portfolio is to provide a consistent flow of income that will generally be much higher than the yield from stock dividends. As interest rates rise and fall this income will vary.

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Fixed income securities also provide a valuable portfolio rebalancing tool. For example, a balanced portfolio of 60% stocks and 40% bonds might shift due to market movements to a 70%/30% mix during a strong stock market cycle. A wise investor would shift 10% of the allocation out of stocks and into bonds to maintain the desired risk level of the portfolio. During down periods for stocks, the allocation might shift to 50%/50% and the investor would shift 10% of the portfolio from bonds to stocks. Without engaging in market timing, the investor has effectively “sold high and bought low” (a discipline many investors ignored, to their regret, in the late-90’s).

Portfolios that experience cash flows in and out can also benefit from a fixed income allocation. During periods of strong stock performance, withdrawals can be taken from the stock side in order to maintain the proper balance and during down markets money can be taken from bonds, bringing the portfolio balance back in line and allowing the stocks to participate in future market rallies. Finally, for taxable accounts new money can be added to the bond side after strong up moves in stocks, avoiding the need to sell stocks and realize taxable gains.

The Maturity Decision

While most investors know that long-term bonds are riskier than short-term bonds, many do not realize that the extra risk is not compensated by higher returns. The chart below shows the risk and returns for various bond maturities since 1964.

![Figure 1: Risk/Reward: Does it Pay to Extend Maturities?](image)

<table>
<thead>
<tr>
<th>Maturity</th>
<th>1-Month T-Bills</th>
<th>6-Month T-Bills</th>
<th>1-Year T-Bills</th>
<th>5-Year T-Note</th>
<th>Long-term Gov't Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Return</td>
<td>6.2%</td>
<td>7.0%</td>
<td>7.2%</td>
<td>7.8%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Annual Standard Dev.</td>
<td>2.6%</td>
<td>3.0%</td>
<td>3.1%</td>
<td>6.6%</td>
<td>11.8%</td>
</tr>
</tbody>
</table>

Many investors today are seeking higher returns on their bond portfolios by extending maturities. Not only is this strategy inconsistent with what we just presented, but it ignores the risk inherent in long-term bonds in a low interest rate environment. Recent performance of long-term bonds has been strong because interest rates have steadily declined. From 1982 to July 2003 as rates have declined from 16% to less than 6%, long-term bond returns were double those of short-term bonds. Since 1926, there has never been another period that saw such a dramatic drop in rates. In the five year period prior to 1982, however, rates rose from 7% to 16% and long-term bond returns trailed One-Month Treasury Bills by more than 10% per year. The implication is clear: if interest rates rise from the current low levels, intermediate and long-term bond prices will fall—possibly dramatically.

TAM’s policy is to limit bond maturities to five years or less in order to reduce volatility and downside risk.

Passive vs. Active Management

If investors or money managers could consistently predict the direction and degree of change of interest rates, the returns of fixed income portfolios could be enhanced. They would simply buy short-term bonds when interest rates are “low” and long-term bonds when interest rates are “high.” Unfortunately, as with stock investing, the research shows that actively-managed bond portfolios consistently underperform their index benchmarks. Predicting the timing and degree of change in interest rates is a fool’s game.

So the decision is narrowed to a choice of indexing a bond portfolio, implementing a buy and hold bond ladder, or selecting a variable maturity approach. Indexed bond portfolios and bond ladders are appealing because they do not involve the risks of interest rate forecasting. On the other hand, they do not optimize the risk/return relationship offered by a variable maturity approach that profits from changing yield curve environments.

For example, bonds purchased in an indexed or laddered portfolio are held through all yield curve changes. So, if the yield curve becomes inverted (usually a sign of uncertain economic times) and 2-Year bonds offer a higher yield than 5-Year bonds, the indexed portfolio cannot take advantage of the more attractive risk/return relationship of the 2-Year bond without incurring “tracking error” to its benchmark. The laddered portfolio is in a similar position due to its strict buy-and-hold mandate. A variable maturity strategy, on the other hand, would shift the maturities of the portfolio as yield curve changes create the possibility for lower risk and higher yields. The variable maturity strategy is not predicting changes in interest rates; it’s simply taking what the current yield curve is offering.

Next Issue:

U.S. versus Global Bonds?
Individual Bonds versus Bond Funds?
Taxable versus Municipal Bonds?

1Information in the Term Structure, Fama, 1984
3The Performance of Bond Mutual Funds; Blake, Elton, and Gruber; Journal of Business 56.3 (1993): 37-403