Internal Fixed Income Portfolio Management

Bonds yields: Up, up and away!

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SNAPSHOT

- Bonds are viewed as a "safe-haven" asset class during periods of stock market volatility. This year, it does not feel that way.
- As bond yields move higher, bond prices move lower. Lower prices can cause unavoidable pain or losses depending on the investment.
- A laddered bond portfolio is designed to help investors benefit from a rising rate environment.

Bond yields are on the move and heading higher! What does this mean for fixed-income investors? Textbooks generally consider fixed-income markets as less volatile than equity markets. Bonds are viewed as a "safe-haven" asset class during periods of stock market volatility. This year, it does not feel that way.

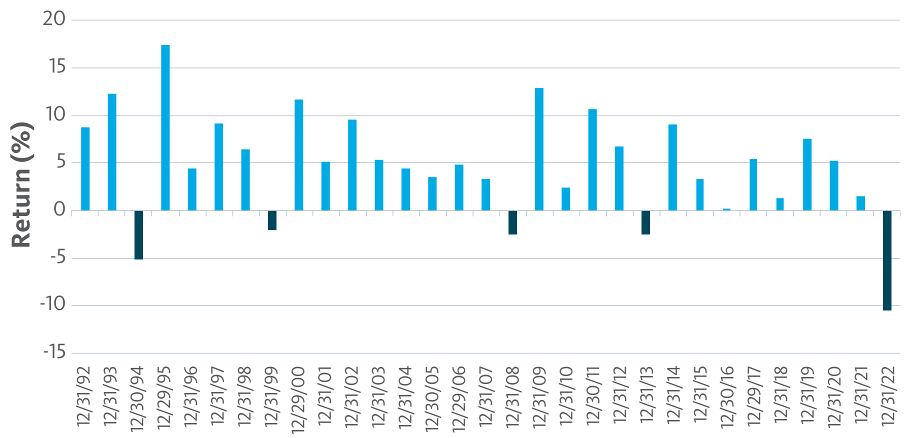
There are two primary explanations for the downtrodden fixed-income market—the first being red-hot inflation. It does matter how you slice and dice inflation data. The Consumer Price Index, Producer Price Index, and Personal Consumption Expenditures all indicate that price levels are elevated—hovering near a 40-year high in some cases. Inflation is most apparent at the gas station, grocery store, hardware store. Energy and food prices have soared on an annualized basis.

Adding to the pressure, the Federal Open Market Committee is currently engaging in an aggressive monetary tightening cycle—which is not friendly for the fixed-income market. As bond yields move higher, bond prices move lower. Lower prices can cause unavoidable pain or losses depending on the investment.

Lower prices, or the anticipation of lower prices, cause many investors to sell their positions in fixed-income funds. This activity exacerbates the downward pressure on bond prices as fund managers sell securities to meet the demand of withdrawals. This is exactly what has transpired within the municipal bond market year to date.

According to a Bloomberg and Lipper data, municipal bond funds outflows totaled roughly $62 billion this year. The end result is negative performance in the form of double-digit losses as seen in Exhibit 1.

EXHIBIT 1: BLOOMBERG MUNICIPAL BOND INDEX



Source: SEI, Bloomberg, Lipper Fund Research. Data as of 12/31/22.

The good news

Credit fundamentals are not flashing warning signs or showing significant deterioration. Interest rates on municipal bonds and corporate bonds are moving higher in conjunction with rising interest rates among U.S. Treasury securities. This type of market activity creates opportunities. As new bonds offer higher rates, prices for existing bonds decline and yields rise.

How the laddered bond portfolio can help.

A laddered bond portfolio is designed to help investors benefit from a rising rate environment. Simply put, a laddered portfolio is constructed by purchasing multiple bonds, each with different maturity dates. The maturity ranges can be short (0–3 years), medium (up to 10 years) or long (up to 30 years). When the one-year bond matures, the proceeds are reinvested at the longest-dated maturity on the ladder. When interest rates are rising, the maturing principal is invested is securities that pay a higher rate than one that just matured.

Keep calm and climb the ladder.

The low-turnover laddered bond strategy does not require the prediction of long-term interest rates; its timed maturities help insulate assets from potential volatility created by large interest-rate swings. The result is intended to create a smoothing effect on the portfolio's ability to generate a steady stream of income. Additional benefits include:

- Liquidity: High-quality bonds can be traded quickly to raise cash if needed.
- Transparency: Holdings and pricing are clearly identified at the time of purchase.
- Tax efficiency: Low-turnover and direct ownership of securities results in control over capital gains.

As interest rates move higher, so do the yields of high quality companies with strong balance sheets and stable cash flow. We have finally lifted off the near zero interest rate environment and in some cases investment grade bonds are yielding more than 5%. This is a perfect time to revisit your asset allocation and investment strategy locking in yield levels we haven't seen for years.

Important Information

This information should not be relied upon by the reader as research or investment advice. This information is for educational purposes only.

There are risks involved with investing, including loss of principal. Bonds will decrease in value as interest rates rise. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations.

No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities. Sample securities may or may not be held within an investor's portfolio.

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