VITAL SIGNS

Conversations about income.

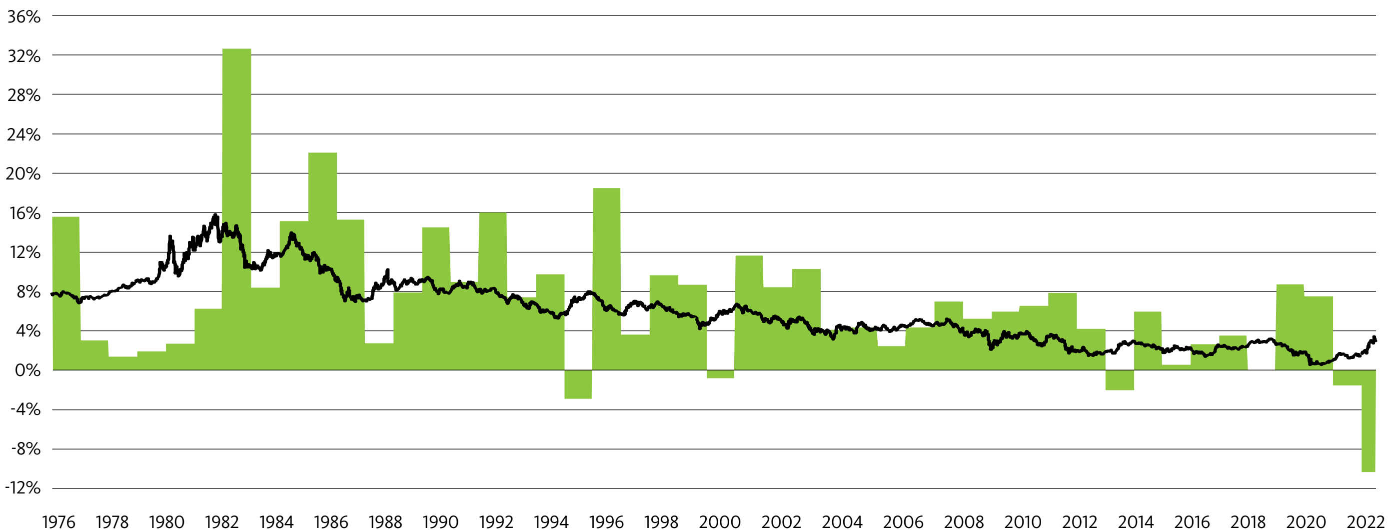
Investors need passive income for various reasons, especially during retirement. But investing in bonds is not always easy or pain-free, as we were reminded in 2022. Looking ahead, do you have the right approach?

Inflation changes the game

For more than four decades, inflation was a mere afterthought, and the prevailing trend for interest rates was down. This was supportive of bond prices, which tend to rise as yields decline. Back then, the key challenge was generating consistent income in a declining-rate environment.

Today, we find ourselves in a new era. The Federal Reserve has raised rates at a historic pace in its fight against inflation. As a result, bonds suffered through their worst year on record in 2022[1]—not exactly the outcome investors fathomed for the more "conservative" part of their investment portfolio. What should investors consider doing now?

Vital sign: It's a new world with new risks



Source: January 1, 1976 through June 30, 2022. Performance prior to 1986 is back-tested. Back-tested performance, which is hypothetical and not actual performance, is subject to inherent limitations because it reflects application of an Index methodology in hindsight. No theoretical approach can take into account all of the factors in the markets in general and the impact of decisions that might have been made during the actual operation of an index. Actual returns may differ from, and be lower than, back-tested returns. **Past performance is no guarantee of future results.**

MIND OVER MATTER

Stretching for yield carelessly comes at a high price. Investors who took on too much interest rate risk (i.e., duration) in 2022 were punished the most.

Today's yields should make it easier to help generate consistent income. Consider using the current higher-rate environment to your advantage.

Don't ignore the risks, especially the emerging ones. Building your bond allocation should be done in the context of your overall investment goals and risk tolerance.

[1]According to the Barclays US Aggregate Bond Index, 2022 was the worst year for bonds since they started recording in 1976.

An ounce of prevention for your fixed-income portfolio

Buying a passive fund that simply follows the Bloomberg US Aggregate Bond Index—one of the most popular domestic bond indexes—may no longer work. It's time to have conversations about updating your fixed-income approach.

Diversifying your income sources should always be done in the context of your goals, personal situation, and risk tolerance.

Traditional bonds	Equity income	Real assets	Non-traditional bonds	Alternative income sources
Although 2022 was scary, remember that in the past four decades, bonds posted annual declines only four times, as measured by the Bloomberg US Aggregate Bond Index. Traditional bonds won't go away, but consider an active approach that may better manage the oft-changing risks.	Stocks that pay dividends may be able to enhance the income streams of traditional bonds and offer added diversification benefits.	Real estate investment trusts (REITs) and master limited partnership (MLP) entities may be able to provide income that offsets the damaging impact of elevated inflation over the long haul.	Bank loans or high-yield credit may enhance the yield profile of an overall income portfolio while active approaches may be able to manage any additional credit risk.	For qualified investors, private equity, hedge funds, market-neutral income funds, and other products may be able to further diversify income sources under the right circumstances for qualified investors.

Portfolio health check

- Step back and acknowledge all the risks facing your fixed-income portfolio, including duration, credit risk, inflation risk, and others. A financial advisor can help you transition into an income-oriented portfolio whereby risks should be accounted for and counterbalanced appropriately.
- A dynamic, diversified asset allocation framework—one that accounts for strategic long-term goals but is also tactical and flexible in the near term—may be the best path forward in the current environment.
- Active fixed-income managers should be able to thrive in this tricky new era. This should allow investors to stay defensive while also positioning opportunistically and taking advantage of periods of elevated volatility.

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Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. Diversification may not protect against market risk. There can be no guarantee your investment objective will be achieved.

There are risks involved with investing, including loss of principal.

Bonds and bond funds will decrease in value as interest rates rise. High-yield bonds involve greater risks of default or downgrade and are more volatile than investment-grade securities, due to the speculative nature of their investments. A company may reduce or eliminate its dividend, causing losses to the fund.

REIT investments are subject to changes in economic conditions, credit risk and interest rate fluctuations.

Investments in securities of MLPs involve risk that differ from investments in common stock, including risks related to limited control and limited rights to vote on matters affecting the MLP. MLP common units and other equity securities can be affected by economic and other factors affecting the stock market in general, expectations of interest rates, investor sentiment towards MLPs or the energy sector, changes in a particular issuer's financial condition, or unfavorable or unanticipated poor performance of a particular issuer. MLP investments in the energy industry entail significant risk and volatility.

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Index returns do not reflect management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Alternative investments are subject to a complete loss of capital and are only appropriate for parties who can bear that risk and the illiquid nature of such investments. Alternative investments:

- Often engage in leveraging and other speculative investment practices that may increase the risk of investment loss
- Can be highly illiquid
- Are not required to provide periodic pricing or valuation information to investors
- Involve complex tax structures and delays in distributing important tax information
- Are not subject to the same regulatory requirements as mutual funds
- Often charge high fees

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