Gage Wealth Management Group

Updated September 2013

Fixed Income Investing

Fixed income investments are typically employed to generate income during retirement and dampen volatility in equity portfolios during pre-retirement. Passive and index management strategies are even more important in fixed income investing than in equity investing because probable long-term returns are so much lower than from stocks, and, therefore, trading and management expenses and underperformance more significantly reduce returns. Just what are the facts on fixed income investing?

ACTIVE FIXED INCOME MANAGEMENT UNDERPERFORMS PASSIVE AND INDEX FIXED INCOME MANAGEMENT. As is the case with stocks, active fixed income managers who try to beat fixed income indexes simply add expenses and decrease investor returns. A 1994 study found that only 16% out of 800 fixed income funds beat their relevant index benchmark over the preceding 10 years. Average performance in another study of 361 active fixed income funds was about -1% annually under their index benchmarks and, like stock funds, past performance didn't usefully predict future performance. DFA, March 2010, calculated the percentage of active fixed income funds that failed to beat their respective fixed income indexes for the period of July 2004-June 2009. Across eight different fixed income markets manager underperformance ranged from 78% for intermediate government bonds to 100% for California municipal bonds. Underperformance by active managers is even greater in fixed income markets than in equity markets.

EXPERTS CAN'T PREDICT THE FUTURE. Active fixed income managers often try to beat fixed income index benchmarks by predicting the direction of the economy and interest rates, and then placing trades to profit from expected shifts. Unfortunately, there's extensive evidence that economists and market analysts can't consistently predict the future of the economy or interest rates with any more accuracy than chance guessing.One study of 36 biannual economic forecasts in the Wall Street Journal found that three-month Treasury bill rates moved in the opposite direction of the expert economists 'consensus forecasts 53% of the time. Consensus predictions on the direction of the benchmark 30 year Treasury bond were wrong 67% of the time. Chance guessing in only incorrect 50% of the time, so predictions of the nation's most eminent economists were worse than guessing. Active managers and economists avoid discussing the issue and are rarely questioned on past failures by the financial press. Admitting that they don't add value would be bad for business. And, the current Federal Reserve Chairman, Ben Bernanke, had been almost consistently wrong in his predictions, having claimed early in the credit crisis that sub-prime deterioration was contained, that the US wouldn't fall into a recession, and that the Fed could fix any problem with its $800B war chest, quickly depleted.

ACTIVE FIXED INCOME MANAGEMENT IS EXPENSIVE. Fixed income investors who choose active managers give up a sizable percentage of the interest from their investments, about 15% to 35%, depending on current interest rates and management expenses. For example, most actively traded fixed income funds today have expense ratios running between 0.5% and 1.0%. An investor in high quality intermediate term tax-free bonds as of 2013 today will receive 2-2.5%. Thus, if fund expense ratios run between 0.5% and 1.0%, our investor will receive a net return of 1.5-2.0%, or around 20% to 50% less than if they'd used a passive investment approach and constructed a laddered municipal bond portfolio with no expense ratio. Had they used passive and index fixed income funds with average expense ratios around 0.2%, their reduction in returns would only have been in the 8-10% range.

RISK AND RETURN IN FIXED INCOME ARE HIGHLY CORRELATED. Even more than stocks, risk and return are highly correlated in the fixed income marketplace. This is so since virtually all fixed income buyers can agree that, say, 4% is better than 3% so fixed markets tend to be highly efficient in pricing. There are no "undiscovered" high return, low risk fixed income investments. All previously issued fixed-income investments fluctuate in value as interests' rates change, with high quality shorter-term income vehicles fluctuating far less than low quality long-maturity or non-maturing income investments like preferred stock. Low and medium quality income investments, like high yield bonds and second mortgage pools, carry a risk that principal and income may decline or fail to be repaid entirely. There is simply no evidence that adding higher risk or longer maturity fixed income vehicles to a portfolio will produce better long-term returns for a given level of risk. In fact, the best risk/return ratios are generally found in short maturity high quality bonds.

High quality income investments include Treasury issues, investment grade corporate bonds, C.D.'s and other U.S. agency guaranteed issues, like GNMA's, and investment grade tax-free municipal bonds. Medium quality fixed income investments include preferred stocks, syndicated bank loan portfolios, asset backed securities, certain high-dividend stocks, like utilities and REIT's, and global government bonds. Low quality income investments include hi-yield or 'junk" corporate and municipal bonds, stocks with abnormally high dividends, like CMO's and some REIT's, private uninsured trust deeds on real estate, and a variety of "structured product" derivatives.

The pricing efficiency and risk in fixed income marketplaces is overt and obvious in comparison with pricing and risk in equity markets. For example, in Fall 2013 ten year US Treasuries yield around 2.7%, good quality preferred stocks yielded around 8%, and better quality hi-yield junk bonds yielded around 5%. Anyone who invests would, of course, prefer a 5% or 8% return to a 2.7% return. The problem is that unlike risk in equities, where long-term investors who can tolerate risk in the form of volatility are statistically likely to receive higher long-term returns in small and value stocks, investors in higher yielding lower quality longer maturity fixed income investments have less chance of being rewarded for taking greater risk.

NO FIXED INCOME INVESTMENT CAN BE CONSIDERED ABSOLUTELY SAFE. No fixed income investment, or any investment, for that matter, should ever be considered absolutely guaranteed and absolutely safe. Research by Dr. Reinhart and Dr. Rogoff, outlined on this site, clearly shows that sovereign debt (Treasury) bond defaults are common throughout economic history. One reason is that little if any legal recourse is available to foreign debt holders. In 2011, even US Treasury issues were downrated. Corporate bonds have varying default rates in various economic conditions and default rates are also a function of bond quality. Interestingly, in 2010 only four US corporations received AAA bond ratings. Typical 10 year default rates for investment grade bonds range from around 3% for BBB's to under 0.5% for AA's. Municipal bonds typically have lower default rates than corporate bonds, again depending upon economic conditions and type of bond.

LONG MATURITY BONDS ARE MORE VOLATILE IN PRICE AND RISKY. Prices on long-maturity or non-maturing fixed income investments fluctuate much more than prices in short or intermediate maturity fixed income, generally defined as anything maturing in eight years or less. This is due to the risk of inflation eroding purchasing power when interest rates rise. As a very rough rule of thumb, a 1% increase in the interest rate marketplace will cause existing 1-year bonds to decline 1% in value, at 5 years, 5%, and at 20 years, 10-20%.

One protective strategy is to construct bond maturity ladders. For example, a portfolio might hold approximately equal weights of municipal bonds maturing from 2011 through 2016. When the 2011 bonds mature, 2017 bonds are purchased, and gradually the portfolio marches forward in time obtaining bonds with seven year maturities from money maturing every year. Whether rates rise or fall, new money is always available and current interest rates, high or low, are always being sampled. Since 1982, a time when interest rates were at record all-time highs, this strategy generally hasn't worked as well as buying all long-term bonds. However, no one could have known in advance that America was about to experience a 30 year decline in interest rates and the biggest bull bond market in our history. And, as of 2013, interest rates don't have any further to fall since short-term rates are effectively zero and most bond yields are at or near 50 year lows. Very roughly, long-term data suggest that interest rates fall and rise in 10 to 20 year cycles and it is virtually certain that at some point interest rates will begin to rise, hurting current bond holders.

DETERMINE WHETHER TAXABLE OR TAX-FREE BONDS OFFER THE BEST AFTER TAX YIELD. Taxes should always be considered when constructing a fixed-income portfolio in a taxable account. If additional income from investments will be taxed in the two or three highest tax brackets, it is usually in the investor's advantage to own tax-free municipal bonds. Yield spreads between taxable and tax-free bonds vary for a variety of reasons. As of 2013, municipal bond yields are relatively high compared to taxable bonds. Municipal bonds offer no advantage for income taxed in lower brackets.

FIXED INCOME INVESTMENTS ARE UNLIKELY TO OFFER ASSET GROWTH. Within Modern Portfolio Theory, fixed income investments are used for income or to increase stability in equity portfolios. They should not be expected to grow in value, though they may fluctuate in value, and they should not be used for speculative trading, since, as noted above, the economy and interest rates are unpredictable and professional bond traders underperform their respective indexes in all fixed income categories.

BOND MARKET PRICING IS OPAQUE. Investors may occasionally come upon claims made by sales oriented firms that they'll get special deals on bonds or benefit from tax-loss bond swaps and other bond trading or selling strategies. The efficiency of bond markets, the failure of actively managed bond portfolios to outperform bond indexes, and the lack of any hard data to show that indexes can be improved upon, all suggest that such claims are without merit.

GLOBAL FIXED INCOME ENHANCES DIVERSIFICATION. Most US investors are familiar with and have exposure to some non-US dollar denominated equities in international developed or emerging markets. Far less common is exposure to non-US dollar foreign fixed markets even though about 60% of all global investment grade debt is not issued by the US.

CONCLUSION: Investors interested in fixed income investments should employ passive and index strategies, like bond ladders and bond indexes, buy top quality issues only for stability, diversify globally, and hold all individual issues to maturity. Investors should avoid actively managed fixed-income mutual funds and actively managed fixed income accounts since management expenses very significantly reduce returns.