Fixed Income Securities: The Classic Tool for Constructing Diversified Portfolios

Paul Mottola
Managing Director
Head of Capital Markets

For almost a decade, Advisors and their clients enjoyed a robust bull market that had inevitably influenced the thought process around portfolio construction. This extended period of low interest rates, strong equity returns, and muted volatility likely dampened the desire to diversify away from equity securities through the use of high-quality fixed income securities in the portfolio construction process.

But it wasn't long ago, depending on the client's profile and investment objectives, that Advisors built portfolios that contained some allocation to fixed income securities, along with other asset classes, such as single-name equities.

The more recent expansion, and the resulting shift of assets to fee-based programs, has contributed to the monumental growth of the Exchange-Traded Fund (ETF) market, and, at the same time, dramatically changed the way many individual investors access and think about fixed income in their portfolios today. The general model portfolio construct of these fee-based programs is to use a sector-based approach to fixed income allocations, using fixed income ETFs as a leading implementation tool. These ETFs are an efficient way to get market exposure, especially in hard-to-invest sectors such as High Yield. However, it is important to recognize some key structural differences versus actual bonds when constructing a portfolio. In light of current market conditions, consideration should be given to reviewing the key benefits associated with constructing a traditional bond portfolio.

Paul Mottola leads Incapital's Capital Markets team and drives the firm's InterNotes® program to offer individual investors access to new issue corporate debt.

Throughout his career in financial services, Mr. Mottola has held various leadership positions, including 20 years at Merrill Lynch, where he was Head of Equity and Fixed Income Syndicate for the Global Wealth Management Division, and six years at Barclays Wealth and Investment Management as the Head of the Trading and Capital Markets platforms. Most recently, Mr. Mottola was a Managing Partner at PCM Management Consulting, LLC.

Features of Fixed Income Securities and Fixed Income ETFs

Fixed Income versus Fixed Income Exposure

The traditional approach to using fixed income in a portfolio has generally been to select securities that fit within a client's investment objectives and overall risk profile. Investors need to consider the securities' credit quality, interest rate risk, and time horizon, along with issuer diversification. Bond investors expect to receive defined cash flows that match their goals and a return of principal at maturity (absent issuer defaults). Such cash flows help support future planning or savings goals, fund living expenses, add to college saving plans, or even put money aside for charitable contributions.

The portfolio objective to track a specific market index has resulted in a shift away from the traditional approach of bond allocations and instead has contributed to the explosive growth of ETFs over the past decade. In fact, according to data from State Street Global Advisors, the inflows for ETFs in 2017 topped $464 billion, with bond ETFs attracting $126 billion for the year and $6.5 billion in December alone.[1]

The multiple holdings within a bond ETF can accomplish many important investment objectives, such as issuer diversification, efficient exposure to desirable parts of the fixed income market and sector diversification. It is the ease of tracking and liquidity that has resulted in many investors using them like stocks and to access sectors that are complicated or hard to invest in, such as emerging markets and high yield.

That ease of use has resulted in investors now confusing fixed income exposure with actual fixed income. The equity-like qualities of a bond ETF means that coupon payments, a critical component in the traditional approach to portfolio management, are converted to periodic dividend payments that aren't necessarily predictable. While bond ETFs have strong market liquidity, there is generally no end date (except for term-funds) when investors receive back their capital, unlike a traditional bond that has a fixed maturity date.

Another important consideration is the interest rate sensitivity of fixed income securities and bond ETFs. Both have interest rate, market and credit risk. While bond ETFs have strong diversification that mitigates the market and credit risk, they generally have a fixed interest rate duration, meaning that the interest rate sensitivity generally remains constant over time. Conversely, fixed income securities have single security market and credit risk. However, given that they have a fixed maturity date, their interest rate duration will slowly decline over time as the maturity date grows closer. This is an important feature to consider, especially with the risk of rising interest rates.

Implementation Strategies in a Rising Rate Environment

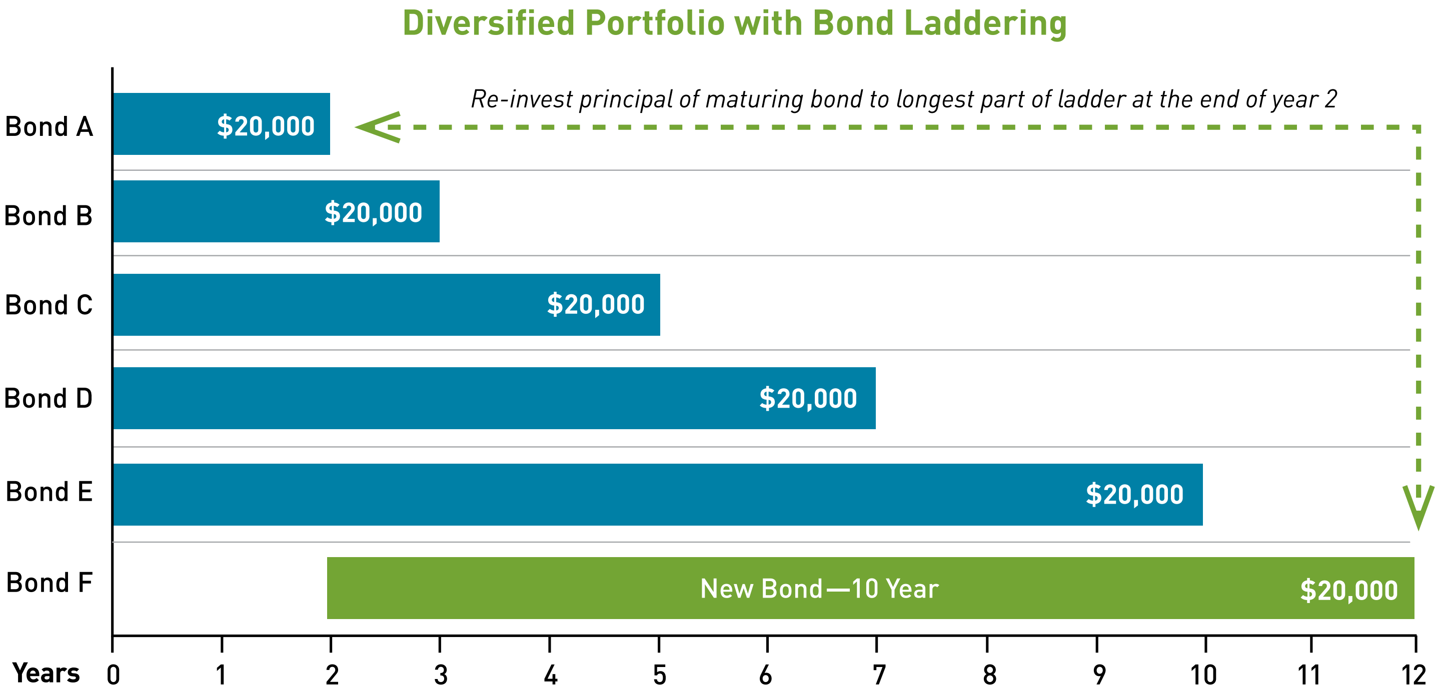
Bond Laddering

The stage is set for the possibility of more Fed rate increases – something every investor should consider when reviewing fixed income portfolios. Investors can implement a strategy to mitigate rate exposure and be positioned to invest at potential higher rates with an investment strategy called bond laddering. Simply stated, you make your bond purchases in multiple issues with different maturity dates, staggering these purchases like steps on a ladder. When the first bond matures, the proceeds are reinvested in a bond with a maturity date matching the longest step of the original ladder. The strategy helps mitigate interest rate risk by reinvesting maturing proceeds at potentially higher interest rates and provides the opportunity to reassess the credit risk you have in the portfolio. Bond laddering is a common and effective way to construct bond portfolios and to provide exposure to many parts of the yield curve – a strategy that is especially relevant in a potential rising interest rate environment.

***Illustration A** shows the initial investment of $100,000 that is split, or laddered, into five bond issues with varying maturities – 2, 3, 5, 7 and 10 years. When the 2-year bond (Bond A) matures, the principal amount is reinvested into a new bond at the longest point of the original ladder. In this example the principal was reinvested in a new 10-year bond (Bond F). The laddering strategy is to reinvest shorter maturities as they come due into longer maturities, thereby creating a continuous cycle to replenish the ladder.* ***Illustration B** shows how the portfolio would be structured at the end of year 2. The goal is to give investors the flexibility to either avoid or take advantage of changing interest rate and/or credit market environments.*

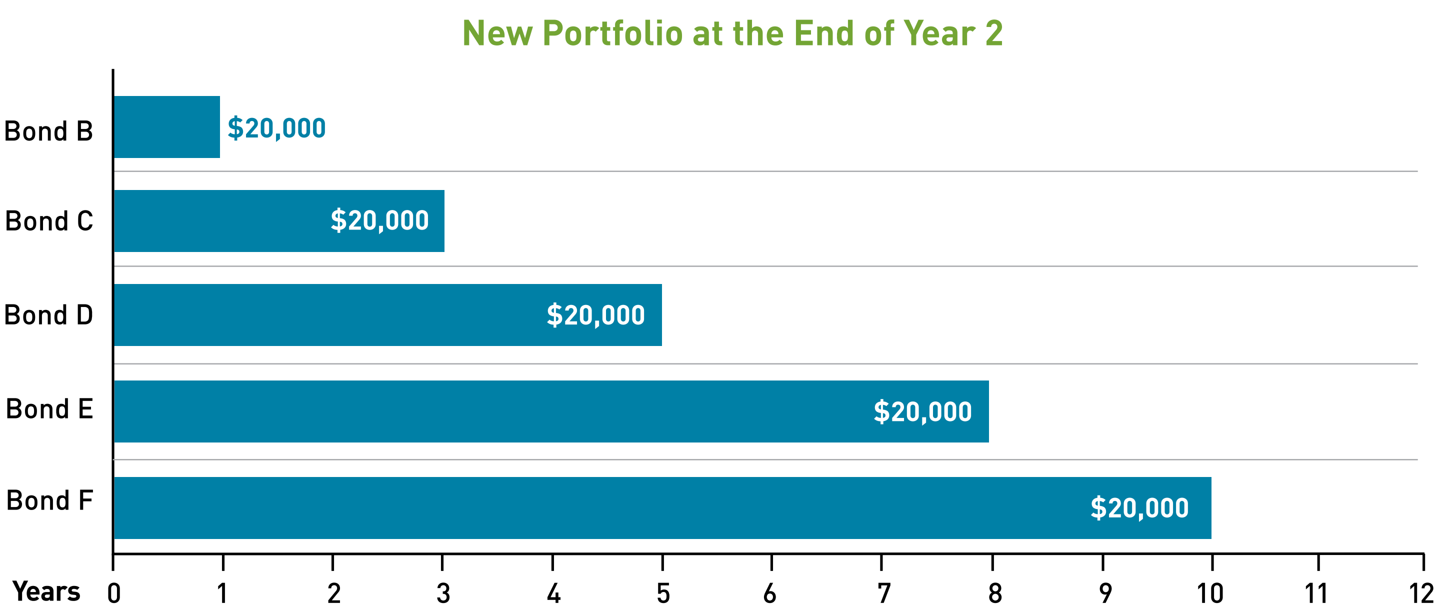
[1] State Street Global Advisors – US-Listed ETF Flash Flows: A Fast Start to 2018

Illustration A



Staggered maturity dates at different intervals allow for reinvestment at longest point of ladder as bonds mature.

Illustration B



These charts are for illustrative purposes only and are not indicative of any investment.

Fixed Income Designed for Individual Investors

New Issue Corporate Bonds

Traditional corporate bonds issued in the primary market are typically only available to the largest institutional investors. This accessibility issue is also a contributing factor to the growth of bond ETFs among individual investors. But some new issue corporate bonds, such as InterNotes®, have been designed specifically for purchase by individual investors. These bonds are issued by many corporations and organizations and are offered with a diverse set of structures, maturities, coupons and credit ratings. Available in $1,000 increments, InterNotes® have a fixed offering price at par and include the flexibility of a weekly offering period, meaning individual investors are not at a disadvantage to institutional investors and not subject to either premium or discount pricing. The extended offering period provides investors with ample time to make an informed decision and understand how it will impact their portfolio.

Take Another Look at Traditional Fixed Income

The monumental growth of fee-based programs has largely expanded the bias toward a sector-based approach to constructing portfolios, and, by extension, how Advisors manage the fixed income exposure in these portfolios. This has generally resulted in a broader acceptance of bond ETFs over the past decade as a main source for fixed income exposure. As a result, we may have inadvertently trained investors to think that the fixed income exposure they get from bond ETFs is true fixed income. However, while these instruments possess many important benefits, they don't offer many of the characteristics of fixed income securities – specifically individual bonds – including the simplicity of implementation in client portfolios, the certainty of cash flows, and the return of principal at maturity.

Given the current market environment, it may be timely to re-evaluate how to fill fixed income asset allocation buckets in your clients' portfolios and consider the characteristics of bonds in relation to the fixed income exposure you receive with bond ETFs.