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The Golden Age for Bonds Is Over – Time to Get Tactical

Over the past 15 years, investors have endured the end of long bull markets in both US equity markets and real estate. We believe that bonds are next. The Federal Reserve is scheduled to “taper” its purchases of long maturity bonds by the end of 2013 and eliminate these purchases entirely by mid-2014. The Fed has also indicated that short term rates might rise from their current near 0% level sometime in 2015. A similar retreat from aggressive monetary policies in the early 1950s prompted a severe sell-off in long maturity investment grade bonds (see circled area in chart below). If history repeats, as we expect, then bond investors could endure an extended period of price declines and poor returns, especially relative to inflation.

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Source: RiverFront Investment Group, Federal Reserve

We believe that investment success in this rising-rate environment will require a flexible, tactical approach to managing fixed income portfolios. Historically, equity and real estate holders who did not sell during bear markets eventually saw their portfolios fully recover; bond investors have not been so fortunate. Even when a bond portfolio ultimately recovered its nominal value following a bear market, its losses relative to inflation were permanent. Thus, fixed income investors may have an even greater need for tactical risk management strategies than equity investors.

Investors in or near retirement cannot tolerate permanent losses to their portfolios’ purchasing power, but they are often reluctant to endure short-term volatility. RiverFront has addressed this dilemma with a dynamic allocation approach to both equity and fixed income asset classes. Additionally, we offer two portfolios — Conservative Income Builder, which has a 3-5 year time horizon with a 30% equity/70% fixed income benchmark allocation; and Moderate Growth & Income, which has a 5-7 year time horizon and a 50% equity/50% fixed income benchmark allocation. However, some investors do not want any equities or prefer to customize their equity solutions. These investors may benefit from RiverFront’s tactical fixed income strategies in a more focused fixed income solution.

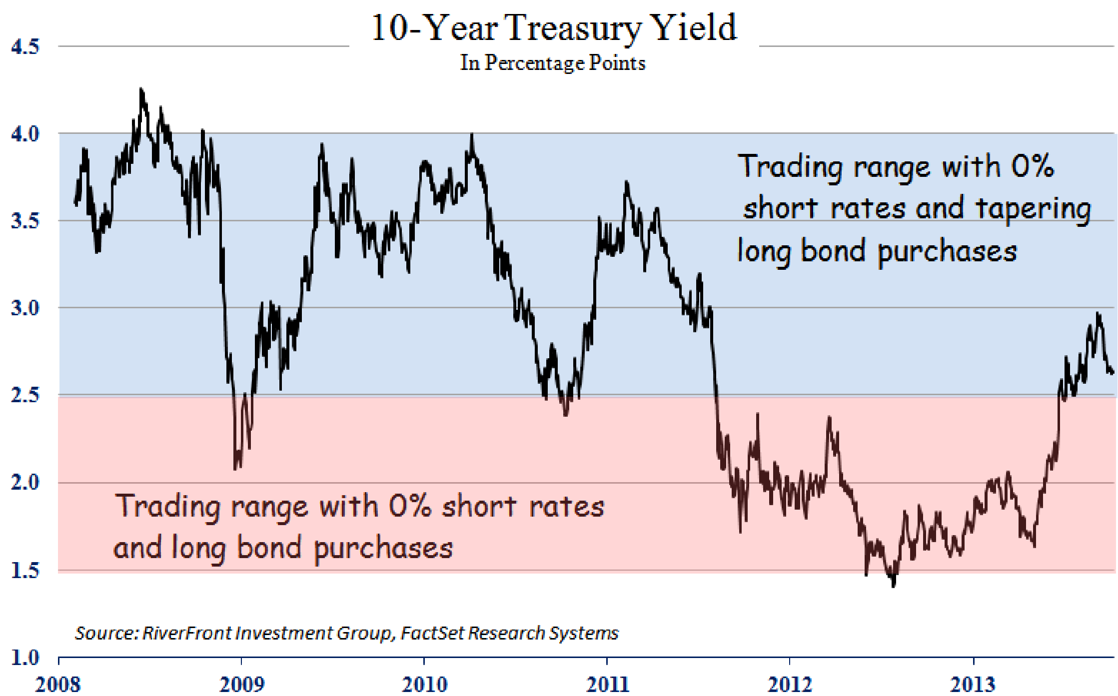
PREPARE FOR A BEAR MARKET IN BONDS

A review of bond market history underscores the potential downside for bond prices once the Fed begins to withdraw from its current aggressive policies. The Fed used comparable policies in the 1940s and early 1950s to combat the heavy debt burdens arising from World War II, keeping interest rates near zero and enforcing an explicit cap of 2.5% on long interest rates. As the Korean War wound down in the early 1950s, the Fed removed its cap on long rates (the equivalent of today's quantitative easing, or "QE") and slowly raised rates from near zero.

The bond market responded to these policy changes with a steady increase in interest rates and persistent declines in bond prices. By the late 1950s, this bear market had ended and interest rates stabilized in a 4–5% range for much of the next 10 years. (see chart above). We believe that rates and bond prices are likely to mimic this pattern from the 1950s, with 10-year Treasury yields rising toward 5% in the next few years.

A two-phase bond bear market

We expect that 10-year Treasury yields will rise toward 5% in two distinct phases. When the Fed begins tapering its QE purchases of long maturity bonds, we think yields will likely rise toward 4%, the top of the 2008 through 2011 trading range. This range was consistent with zero short rates without the Fed's aggressive purchases of long maturity Treasuries (see chart below). Investment grade bonds with 10-year maturities could fall as much as 10% in price during this first phase, in our view. The top of this range should hold so long as the Fed does not raise short rates, since in the past 10-year Treasuries have not traded much above 4% when short rates has been near 0%.



Although QE purchases are expected to end in 2014, the consensus within the Fed is that short rates will remain near zero until at least 2015. Thus, we do not think the second phase of the bear market will start until rate increases are imminent. Assuming that the Fed repeats its successful 1950s era withdrawal from QE and zero interest rates, these interest rate increases will be timely and inflation will not become a problem. In this case, the 10-year Treasury yields could stabilize between 4% and 5%, the range seen throughout the late 1950s and early 1960s. Investors in 10-year maturity bonds could endure an additional 10% price decline under these optimistic policy and inflation assumptions. Thus, across both bear market phases, investors in a static 10-year bond could lose as much as 20%, while investors in popular mutual funds tied to the Barclays US Aggregate Bond Index could lose between 10% and 15%, in our opinion.

A POTENTIAL SOLUTION

Tactical fixed income management requires the flexibility to significantly alter the maturity structure of a portfolio. Maturities can be shortened when there is an overwhelming risk of rising rates and lengthened during periods of perceived interest rate and price stability. Additionally, RiverFront's tactical mandate permits substantial variation in credit quality and currency composition, encompassing a wide spectrum of fixed income markets.

Our flexible approach contrasts sharply with common fixed income portfolio practice, which typically restricts managers to a narrow range of maturities, sectors, and/or credit quality. After the equity bull market ended in 2000, volatility over the subsequent decade challenged the prevailing "buy and hold" approach to mitigating equity risks and the "style box" approach to portfolio construction. Buy and hold fixed income strategies pursued by most mutual funds and exchange-traded funds (ETFs) were successful during the 30-year bond bull market. We believe a tactical fixed income strategy will now be required.

RIVERFRONT'S TACTICAL APPROACH TO FIXED INCOME

RiverFront's Price Matters® process for estimating potential returns and downside risks is the primary driver of our fixed income strategy. With interest rates near record lows, our Price Matters calculations indicate a nearly 100% probability that longer-maturity bonds will lose money relative to inflation over the next ten years. This is similar to the level of overvaluation equities reached at the end of the 1999-2000 technology bubble. Therefore, we are prepared for an extended period of poor returns from fixed income investments, and our current strategy is primarily focused on capital preservation. We expect to maintain an average maturity of less than 2.5 years until 10-year rates approach 4% and the first phase of the bear market has concluded.

Once higher yields (lower bond prices) improve bond return potential on our Price Matters evaluation, we will likely increase the portfolio's average maturity and incremental yield. Our assessment of economic growth will determine how aggressively we lengthen the maturity of our fixed income portfolio. Strong economic growth could shorten the lag between the end of the first phase of the bond bear market (end of QE) and the beginning of the second (short rates start to increase), and therefore reduce our willingness to extend maturities. Conversely, if growth remains anemic then zero interest rates may extend beyond 2015 and we could be more aggressive in our fixed income strategy.

THREE STRATEGIES TO COMPENSATE FOR LOW YIELDS AND LOW POTENTIAL RETURNS

The challenge presented by a short maturity bond strategy is that short investment grade bonds have low yields and potential returns are low. We currently use three strategies to help us compensate.

Rolling down the yield curve

First, we do not manage our fixed income portfolio to a constant maturity, unlike typical bond funds or ETFs; we can allow our bonds to mature. A 3-year bond that has aged into a 2-year bond is typically priced at a lower interest rate. This provides a modest price appreciation that adds incremental return to the yield as the bond "rolls down" the yield curve.

An added benefit of rolling down the yield curve is that bonds get less risky as they approach maturity. This offers some protection from rising interest rates. Thus, our portfolios are more likely to recover any nominal losses caused by rising rates as our bonds mature and pay off at face value. By contrast, most mutual funds and ETFs maintain a relatively constant maturity; therefore, they generally do not recoup losses in a rising rate environment.

Short-maturity high-yield bonds

Short-maturity high-yield bonds are the second and, in our view, more powerful augmentation to our strategy. These bonds offer yields almost as high as longer maturity alternatives (4.5% to 5.5%), with lower interest rate and credit risks, in our view. Rating agencies give the same rating to all of a company's bonds regardless of maturity (assuming comparable seniority), i.e., a company's 2-year bond gets the same rating as its 10-year bond of like seniority.

Companies have issued record amounts of high-yield debt and amassed substantial cash reserves thanks to the liquidity provided by QE. In many cases, high-yield borrowers have more than enough cash to pay off all of their short-maturity bonds. Therefore, we believe that short-maturity high-yield bonds have far less risk than their ratings suggest. With low interest rate and credit risks and yields of up to 5%, we think short maturity high yield bonds are the most attractive investment in the fixed income markets.

Floating Rate Corporate Loans

Floating rate corporate loans combine relatively short maturities (typically less than five years) and floating interest rates, so they can offer protection from rising interest rates and yields of more than 4%. Although issued by high-yield borrowers, the senior secured nature of many of these loans makes us comfortable with their credit risk.

On the downside, we are concerned with the rapidly rising popularity of floating rate corporate loans. With record amounts of assets pouring into corporate loan mutual funds and ETFs, we are increasingly concerned about liquidity risks if and when some investors decide to exit. Consequently, we have recently trimmed our weighting and will likely continue to do so as investors keep pouring in and prices keep rising.

A WORST CASE SCENARIO

We have outlined a fairly optimistic scenario in which inflation remains contained, but we must acknowledge the risk that Fed policies could result in 1970s era double-digit inflation. During that time, bond investors suffered 38% inflation-adjusted total return losses (based on 10-year Treasuries). We emphatically disagree that Fed policies under Ben Bernanke have made such an outcome inevitable — the Fed successfully withdrew from similar policies in the 1950s without generating inflation. In our view, inflation becomes a problem only if the new Fed leadership proves as susceptible to political pressure as did Arthur Burns (Fed Chairman from 1970-1978).

We cannot predict how Janet Yellen, the likely new Fed Chairman, will react to political pressures in the coming years, and most of the Open Market Committee members (the committee that sets interest rates) have not yet been named. This uncertainty over future Fed policy and its potential consequences for the bond market are perhaps the best argument for a nimble, flexible, tactical approach to setting fixed income strategy.