Perspectives
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Bumgardner Morrison Wealth Management, LLC

1501 E. Mockingbird, Suite 300
Victoria, TX 77904
361-575-0271

Fixed-Income Strategies for a Rising-Rate Environment

By Rick Spencer, CFA, 1st Global Fixed-Income Trader

Interest rates have begun to trend higher after bottoming in July 2016. After reaching a low of 1.36 percent last year, the 10-year Treasury yield recently hit 2.6 percent and currently rests at a 2.56-percent yield, as of early March. Higher interest rates have benefited bond buyers with higher starting yields but could become a source of concern if rates continue to climb.

The new higher-rate environment raises questions for investors, such as "Does my investment strategy still make sense?" For many investors, laddering bonds from three to seven years makes sense, as it allows increasing income over time as bonds mature, allowing the reinvestment of proceeds into new bonds with higher coupons. This maturity range affords excellent diversification potential because of the large number of issuers and industries represented.

The long-expected rise in rates has prompted other investors to look for a magic bullet that will protect them against higher rates. As you might expect, there is no one magic bullet, but there are types of bonds and CDs that can provide hedges against rising rates.

Step-Up Coupons Can Provide Some Protection against Future Rate Increases

A step-up CD or bond is a security with a coupon that increases ("steps up"), at predetermined dates, while the bond is outstanding. Step-up CDs are issued by major banks, typically in maturities of three to five years. These CDs are generally callable every three months. The starting coupon for the step-up typically is lower than fixed-coupon CDs of the same maturity, but as the coupon steps up, it will overtake that of the fixed-rate CD if it is not called.

Step-ups work best as complements to fixed-rate CDs. If you buy a five-year step-up CD, it might be outstanding for three months or six months before being called; in a rising-rate environment, it might stay outstanding until maturity. As the coupons rise, the potential for a call increases. The investor should be comfortable with monitoring the portfolio and occasionally shopping for new issues.

Step-up bonds are issued less frequently than CDs, so the best offerings are typically in the secondary market. Like the CDs, they are generally callable quarterly or semiannually. There is great diversity in the coupon steps, call schedules and maturity dates, and liquidity should be considered, as well.

Floating-Rate Bonds Will Pay Increasing Coupons If Underlying Rates Rise

Floating-rate securities make interest payments that float or adjust periodically based upon predetermined benchmarks. The London Interbank Offered Rate (LIBOR) and CPI are commonly used benchmarks. Financial firms issue most of the floaters currently outstanding. The offerings normally are subordinated to the firm's fixed-rate debt.

"Floaters" generally pay interest quarterly, and the coupon rate typically resets with each payment. Some issues have different reset schedules, so it's important to study all of the details before making a purchase.

Navigating the floating-rate bond market can be challenging — coupon and call schedules can be complex, and trading in the issues can be thin. For some investors, mutual funds or ETFs might be more appropriate to gain exposure to this segment of the market.

Survivor Option Bonds Allow Older Investors to Protect Capital While Getting Competitive Yields

A survivor option bond is a bond that allows heirs to redeem the bonds at par following the death of the bond owner. Many older investors limit their investing to short or intermediate maturities, as they don't want their heirs to be stuck with losing positions in bonds. The survivor option feature effectively puts a floor under the bond's value, within certain limitations. During a period of rising rates, it helps to provide the estate a substantial amount of capital appreciation that's potentially greater than that of the market.[1]

Investors should consider that the survivor option will likely only come into play over a longer timeframe for these bonds. If the owner passes away while the bond is at a premium, the survivor option does not provide any benefit.

For most investors, the straight bond ladder provides diversification, periodic income and flexibility to their portfolio strategies. For those with unique situations or who want to structure their portfolios for specific interest rate scenarios, they may want to explore some of the alternatives to conventional bonds. Having a conversation with your advisor can help you further understand these alternatives and whether or not they are suitable options for your fixed-income portfolios.

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[1] *"Survivor's Options Bonds." Janney Corporate Credit, February 2016.*

Investment Shock Absorbers

By Jim Parker, Dimensional

Ever ridden in a car with worn-out shock absorbers? Every bump is jarring, every corner stomach-churning and every red light an excuse to assume the brace position. Owning an undiversified portfolio can trigger similar reactions.

In a motor vehicle, the suspension system keeps the tires in contact with the road and provides a smooth ride for passengers by offsetting the forces of gravity, propulsion and inertia.

You can drive a car with a broken suspension system, but it will be an extremely uncomfortable ride, and the vehicle will be much harder to control, particularly in difficult conditions. Throw in the risk of a breakdown or running off the road altogether, and there's a real chance you may not reach your destination.

In the world of investment, a similarly bumpy and unpredictable ride can await those with concentrated and undiversified portfolios or those who constantly tinker with their allocations based on a short-term rough patch in the markets.

Of course, everyone feels in control when the surface is straight and smooth, but it's harder to stay on the road during sudden turns and ups and downs in the market. And keep in mind that the fix for your portfolio breaking down is unlikely to be as simple as calling a tow truck.

For that reason, the smart thing to do is to diversify, spreading your portfolio across different securities, sectors and countries. That also means identifying the right mix of investments (e.g., stocks, bonds, real estate) that aligns with your risk tolerance, which helps keep you on track toward your goals.

Using this approach, your returns from year to year may not match the top-performing portfolio, but they aren't likely to match the worst, either. More importantly, this is a ride you are likelier to stick with.

Just as drivers of suspensionless cars change their routes to avoid potholes, people with concentrated portfolios may resort to market timing and constant trading as they try to anticipate the top-performing countries, asset classes and securities.

Here's an example to show how tough this is. Among developed markets, Denmark was number one in U.S. dollar terms in 2015 with a return of more than 23 percent. But a big bet on that country the following year would have backfired, as Denmark slid to bottom of the table with a loss of nearly 16 percent.[1]

It's true that the U.S. stock market (by far the world's biggest) has been a strong performer in recent years, holding the number three position among developed markets in 2011 and 2013, first in 2014, and sixth in 2016. But a decade before, in 2004 and 2006, it was the second worst-performing developed market in the world.[2]

Predicting which part of a market will do best over a given period is also tough. For example, while there is ample evidence to support why we should expect positive premiums from small-cap, low relative price and high-profitability stocks, these premiums are not laid out evenly or predictably across the map. U.S. small-cap stocks were among the top performers in 2016, with a return of more than 21 percent. A year before, their results looked relatively disappointing with a loss of more than 4 percent. International small-cap stocks had their turn in the sun in 2015, topping the performance tables with a return of just below 6 percent. But the year before that, they were the second worst, with a loss of 5 percent.[3]

While diversification can never completely eliminate the impact of bumps along your particular investment road, it does help reduce the potential outsized impact that any individual investment can have on your journey.

If you've ever taken a long road trip, you'll know that conditions along the way can change quickly and unpredictably, which is why you need a vehicle that's ready for the worst roads as well as the best. While diversification can never completely eliminate the impact of bumps along your particular investment road, it does help reduce the potential outsized impact that any individual investment can have on your journey.

With sufficient diversification, the jarring effects of performance extremes level out. That, in turn, helps you stay in your chosen lane and on the road to your investment destination.

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[1] In U.S. dollars. MSCI developed markets country indices (net dividends). MSCI data © MSCI 2017. All rights reserved.

[2] Ibid.

[3] In U.S. dollars. U.S. small cap is the Russell 2000 Index. Frank Russell Company is the source and owner of the trademarks, service marks and copyrights related to the Russell indices. International small cap is the MSCI World ex USA Small Cap Index (gross dividends). MSCI data © MSCI 2017. All rights reserved.

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RESEARCH & CONSULTING
12750 Merit Dr., Ste. 1200, Dallas, TX 75251 | www.1stGlobal.com | 877-959-8400