

June 4, 2013

from  Montage Investments

## Fixed Income Perspectives: The Chase for Yield Exposes Investors to High Risk

Investors are being bombarded with messages about how to boost yields in today's low rate environment. Individuals are being prompted to move into a wide variety of income producing investments as alternatives to high quality but low-yielding bonds. Market commentators, investment advisors and even the general media are loudly proclaiming that investors should rotate into higher yielding products that can boost current income. What is largely ignored, however, is the downside risk in these bond alternatives and the potential losses that investors may be risking in return for modest potential yield gains. In challenging markets, it is important that investors stay true to their long-term strategies and risk tolerances.

Each individual's unique attitude toward risk and situation should determine the asset allocation in their portfolio, including the portion of assets allocated to core fixed income. A long-term asset allocation strategy is the most influential factor affecting a portfolio's long-term performance. It helps investors stay true to their investment needs and goals, preventing emotional decisions and the temptation to try to time the markets.

Every investor's asset allocation should be determined based on the following considerations:

**1. Investment horizon**

A shorter time horizon, due to age or finite investment goals (such as saving for a house or a child's college expenses), calls for a more conservative asset allocation.

**2. Risk tolerance**

The less comfortable an investor is with principal risk and the potential for large price fluctuations, the higher the allocation should be to lower volatility assets, such as core fixed income.

**3. Income needs**

Investors with ongoing income needs must balance their desired withdrawal rate with their risk tolerance. Higher yields mean higher credit and/or price risk. This is a delicate balancing act in today's low rate environment, and one that must be considered carefully. Higher yield comes at a price of higher potential principal losses.

#### **4. Tax considerations**

Proper asset allocation also considers the tax treatment of investments. Investments should always be considered in light of an investor's tax bracket, state of residence and the type of account in which the securities will be held. All investments should be considered on a taxable equivalent basis when setting an allocation.

For more conservative investors, a high-quality bond allocation doesn't have to mean settling for Treasury bond yields. A balanced approach to bond investing can increase yield while also carefully balancing credit, price, volatility and liquidity risk. A quality fixed-income allocation is not only appropriate for investors with a low risk tolerance, but it also acts as a counterbalance to more volatile asset classes in a more aggressive portfolio.

Since the Fed began quantitative easing (QE), interest rates have been pushed down to historical lows, creating difficult choices for investors who need income. They may find themselves tempted to reallocate assets from low-yielding core fixed income into dividend-paying stocks, junk bonds, alternatives or structured products without considering their well thought out asset allocation. A better plan for income investors is rebalancing from one higher risk asset into another that offers higher income potential, keeping the overall risk tolerance of their portfolios in balance. Needless to say, investors who "reach for yield" without fully understanding the risk/reward characteristics of each asset class may find themselves with a portfolio that is more volatile and carries more credit risk than is consistent with their needs and goals.

Ascent's thorough credit research and experience in searching for value across fixed income sectors can provide a balance of credit strength and enhanced income. While achieving a yield of 5% in today's market is not possible without taking on a level of risk that is incompatible with a conservative fixed income allocation, our strategy can provide significantly higher yield than the widely quoted measure of bond market yield – the 10-year U.S. Treasury.

The risks that investors should consider before reallocating from their core bond allocation in search of higher yields include:

##### **Credit risk**

When considering moving a portion of a core bond allocation to equities or equity-like alternatives (junk bonds), principal/credit risk should be considered. Investors need to understand how an investment has performed through past market cycles, what the historical levels of default or impairment have been and what the impacts on investment returns would be in the event of credit downgrades or defaults.

Dividend-paying stocks (common and preferred) do tend to be less volatile than equities of "growth" companies, but they are still lower in standing in a company's capital structure than senior creditors, like bondholders. Also, they can carry the risk of a reduction or elimination of dividend payments at the company's discretion. Even a slowing in the pace of dividend growth can have a significant impact on a security's pricing. The fact that much of the

dividend payment activity in the equity markets today is being financed by debt issuance rather than by organic growth of revenues and earnings, bodes poorly for the continuity of dividend levels in the future.

Junk bonds posted returns in excess of 15% in 2012, and have continued to perform strongly this year. Yields have dropped precipitously since the Fed began QE, which makes it hard to argue that the continued move into this asset class isn't being driven by investors reaching for yield. While junk bonds can have a place in an asset allocation if the investor's risk tolerance is consistent with their credit characteristics, at current spread levels they offer historically low compensation versus their quality counterparts for the potential principal and price volatility risk incurred. Junk bond returns must also be viewed with an eye toward historical default and recovery rates, and yields should be adjusted to reflect the likelihood that returns may be impacted by credit losses over time.

Structured offerings such as collateralized mortgage obligations (CMOs) and collateralized loan obligations (CLOs) can be a tempting asset classes for traditional core fixed income investors because some carry 'AAA' credit ratings. However, many structured products like these are still at a higher risk of rating deterioration than high-grade bonds if loan defaults rise (we've seen this story before). It is important to note that these highly-rated tranches can contain underlying loans that are rated in the 'B' or 'C' range, a much different credit profile than a core fixed income allocation. These securities, and all the current yield alternatives being offered can behave very differently than high-quality bonds in a changing market environment.

### **Price risk**

Prices for alternative investments are much more volatile than for quality bonds in moving markets. They can move five percent or more in a single trading day, far faster than even most professional investors can react. Investors can easily see a year's worth of interest earnings wiped out in a single trading session. Investors should always understand what the impacts on an investment's price or return will be in the event of a significant change in interest rates. How have these investments performed in past challenging market environments like 2007 through 2011? What would happen to the value of the investment if the Fed tapers its QE program and interest rates rise by 25 basis points (0.25%), 125 bps (1.25%) or even 200 bps to 300 bps (2% to 3%)?

Price risk is also related to the limited liquidity for many of these yield alternative products. There is typically a limited secondary market for high-yield investments even in the best of times. Liquidity is always best at the top of a hot market, but gets much worse as prices start to decline. For a seller, it may be difficult or impossible to get a bid for a particular holding in a downward moving market (if the plan is to move back into quality bonds when the interest cycle begins to change).

### **Transaction costs**

As a result of liquidity limitations, there is usually a fairly large difference between the price an investor pays for a security and the price at which they could sell, even to the same

dealer. Investors may have to hold an investment for a significant period of time to earn enough return to compensate for this bid/ask spread. As market volatility increases, bid/ask spreads tend to widen, so it is even more costly to sell in a down market. High quality bonds tend to have lower bid/ask spreads than junk and structured products, but investors still incur this “invisible” transaction cost when moving out of their quality fixed income allocation into yield alternatives.

Actively trading fixed income securities is generally uneconomical for individual investors. Any yield pick-up available moving monies from a core fixed income allocation to higher yielding alternatives must be considered after the bid/ask spread of the transaction. This is why Ascent tries to keep trading in even their high quality portfolios to a minimum. Our careful credit selection and ongoing credit monitoring helps us minimize sales due to credit concerns, especially in a stressed market environment.

### **Timing risk**

Tactical changes in an investor’s asset allocation carry the assumption of the ability to correctly time the market. Research has shown that not only is an appropriate asset allocation the primary driver of investment returns, but also that no investor has proven able to consistently time the market. Individual investors are at an even bigger disadvantage due to information asymmetry versus the professional traders and broker/dealers, since they are the ones making the markets. Investors who try to time the market by moving into and out of the various yield alternatives being used in lieu of a core bond allocation may find any yield pick-up eroded quickly when there is a market turn and everyone that has also chased yield runs for the exit. Long-term, limited turnover bond portfolios typically face very little timing risk since they are meant to be a long-term allocation, not a tactical one.

Carefully constructing an overall asset allocation is the most important investment decision an investor can make. It is the engine that drives their portfolio’s performance. In today’s confusing low-yield environment, it is more important than ever that clients reevaluate their risk tolerance and asset allocation as a whole before investing based on yield differentials only.



**Brian Tournier**  
Director of Research  
Ascent Investment Partners



**Sandra Pourcillie, CFA**  
Principal  
Ascent Investment Partners

Disclosure: This newsletter is limited to the dissemination of general information pertaining to Ascent Investment Partners, LLC's ("Ascent Investment Partners") investment advisory services and general economic market conditions. The information contained herein should not be construed as personalized investment advice, and should not be considered as a solicitation to buy or sell any security or engage in a particular investment strategy. There is no guarantee that the views and opinions expressed in this newsletter will come to pass.

Ascent Investment Partners is an SEC registered investment adviser with its principal place of business in the State of Missouri. Ascent Investment Partners and its representatives are in compliance with the current registration and notice filing requirements imposed upon registered investment advisers by those states in which such registration or notice filing is required. Ascent Investment Partners may only transact business in those states in which it is noticed filed, or qualifies for an exemption or exclusion from notice filing requirements. Any subsequent, direct communication by Ascent Investment Partners with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of Ascent Investment Partners, please contact Ascent Investment Partners or refer to the Investment Adviser Public Disclosure web site ([www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov)). For additional information about Ascent Investment Partners, including fees and services, send for our Disclosure Brochure using the contact information herein.