A Focus on Fixed Income

It's been approximately a decade since the Great Recession began. By year-end 2008, the U.S. Federal Reserve (the Fed) had *lowered* the target federal funds rate to near-zero and embarked on an aggressive quantitative *easing* campaign, hoping to resuscitate the economy with a big booster shot of lending, borrowing and spending dollars.

Perhaps the economic recovery that followed was a direct result of these and other Fed initiatives. More likely, there were a number of contributing factors. Either way, the Fed has begun to reverse course, restoring its policies and targets closer to historical "norms" through quantitative *tightening* and gradually *rising* rates.

As an investor, what can or should you do to prepare if rates do continue to rise? For that matter, what can or should you do if they don't? As usual, our advice may not be as action-packed as you might crave, but there are a number of solid, evidence-based strategies to guide the way.

Guiding Rule #1: Invest According to a Sensible, Customized Plan
If there's one principle that drives the rest, it's the importance of having your own detailed investment plan – preferably in the form of a written and signed Investment Policy Statement. If you have a personalized plan, you have a touchstone for any and all investment decisions you make, including building and maintaining an appropriate balance between stocks and bonds, as well as determining what to include within your bond portfolio.

In the absence of a plan, you're left with a continuous struggle to predict how, when and if it's time to react to greater events over which we have no control. While there is no guarantee that your plan will deliver the outcomes for which it's been designed, we believe that it represents your best interests and your best odds for achieving your personal goals.

Guiding Rule #2: Let the Evidence Be Your Guide
With your personalized plan in place, invest according to the decades of empirical evidence that helps us understand the overarching roles for which each kind of investment is best suited.

Stocks (Equity) – Stocks or stock funds are the most effective tool for those seeking to build more wealth over time. But along with higher expected returns, they also have delivered a bumpier ride (volatility), with increased uncertainty (market risk) over whether you will ultimately achieve your goals.

Bonds (Fixed Income) – Bonds or bond funds are a good tool for dampening that bumpier ride and serving as a safety net for when market risks are realized. They can also contribute modestly to a portfolio's overall expected returns, but we don't consider this to be their primary role.

Cash – In the face of inflation, cash and cash equivalents are expected to actually lose buying power over time, but it's great to have enough on hand for near-term spending needs. An adequate level of cash reserves also helps you keep your stock and bond holdings invested as planned, so you aren't forced to sell ("cash out") either at inopportune times.

Thus, in performance and predictability, fixed income is meant to be "cooler" than stocks, but "warmer" than cold, hard cash:

	Expected Long-Term Returns	**Highest Purpose**
Stocks (Equity)	Higher	Building wealth
Bonds (Fixed Income)	Lower	Preserving wealth
Cash	Negative (after inflation)	Spending wealth

By keeping your attention focused on these principles, it becomes easier to recognize that, even when your bond holdings are plodding along compared to the rest of your portfolio, the more important consideration is whether they are fulfilling their highest purpose in your total wealth management.

Guiding Rule #3: Bonds Are Safer; They're Not Entirely Safe
To further maintain your financial resolve in the face of complex and often conflicting fixed income news, it may help to understand that, compared to stocks, bonds have historically exhibited *lower* volatility and market risks, along with commensurate lower returns. But they do exhibit *some* volatility, as well as some market risk. Because bonds represent a loan versus an ownership stake, they are subject to two types of risks that don't apply to stocks:

- **Term premium** – Bonds with distant maturities or due dates are riskier, so they have returned more than bonds that come due quickly.
- **Credit premium** – Bonds with lower credit ratings (such as "junk" bonds) are also riskier, and have returned more than bonds with higher credit ratings (such as government bonds).

When reading bond market headlines about interest rates, yield curves, credit ratings and so on, these are the two risks and commensurate return expectations that are rising or falling along with the news. As such, as alarming or exciting as bond market news may become, compared to stocks, the levels of volatility and degrees of risk need not – and really should not – be as extreme as we must tolerate in equity/stock investing to pursue higher expected returns. The decisions you make about the risks inherent to your bond holdings should be managed according to their distinct role in your portfolio, as we'll explore next.

Guiding Rule #4: Act on What You Can Control

So, where does all this leave you as a long-term investor? Here are some proactive steps you can take to best position your fixed income investing across various market conditions.

Are your fixed income holdings the right kind, structured according to your goals? Just as there are various kinds of stocks, there are various kinds of bonds, with different levels of risk and expected return. Because the main goal for fixed income is to preserve wealth rather than stretch for significant additional yield, we typically recommend high-quality, short- to medium-term bonds that appropriately manage the term and credit risks described above.

Are you keeping an eye on the costs? One of the most effective actions you can take across all your investments is to manage the costs involved. When investing in bond funds, this means keeping a sharp eye on the expense ratios and seeking relatively low-cost solutions. For individual bonds, it's especially important to be aware of opaque and potentially onerous "markup" and "markdown" costs. While these costs don't typically show up in the trade report, they are very real, and can detract significantly from your end returns.

Are your solutions the right ones for the job? Whether turning to individual bonds, bond funds or similar solutions such as Certificates of Deposit (CDs), your fixed income portfolio should strike a harmonious balance between necessary risks and desired returns – within the context of your own plans and according to the distinct role that fixed income plays within those plans.

To achieve this delicate balance, it can make good sense to seek the assistance of an objective adviser to help you weigh and analyze your options, determine a sensible course for your needs, and implement that course efficiently and cost effectively. Your advisor also can help you revisit your plans when market conditions may cause you to question your resolve, or your own circumstances may warrant judicious adjustments. An experienced ally can advise and inform you about costs, strategies and other considerations before you make your next moves.

Managing the Unmanageable Markets

In short, whether interest rates are rising, falling or standing still, it remains perennially good advice to heed the decades of empirical evidence on how to earn long-term returns and manage related risks within your total portfolio approach. That means looking past breaking news and fickle forecasts. (Even if interest rates are on the rise, we don't know how the markets will react.) It means detecting and minimizing costs. It means focusing on your personal goals and ensuring that your portfolio stays optimized accordingly. For stocks and bonds alike, these are the most reliable principles for navigating uncertain markets as certainly as we're able.