Lauterbach Financial Advisors, LLC

Market Insights

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Options for Stretching for Yield

In this commentary, BAM Fixed Income Advisor Brian Haywood discusses the challenges advisors face in a low interest rate environment and some potential solutions.

In low interest rate environments, many fixed income investors lose their discipline and tend to do one of three things:

- Lower the credit quality of their investments
- Stay on the short end of the yield curve
- Extend maturities to the far end of the yield curve

Let's take a look at each of these situations.

Challenge One: Lowering Credit Quality

First, it is important to remember one of the key roles of fixed income, which is to provide stability to portfolios. The goal when investing in fixed income is to lower the volatility of a portfolio while preserving capital. It is not to stretch for yield in attempts to generate higher returns.

Investors who wish to generate additional returns should look at their allocation to stocks and bonds, then see if adjustments need to be made to produce higher expected returns. Historically, risk has been much better rewarded on the equity side, not on the fixed income side.

For those adamant about taking credit risk, they should do so in a diversified manner to mitigate their risk. One such way is through DFA's Short-Term Extended Quality Portfolio. In addition to diversifying holdings across countries outside the United States, the fund can also invest in lower-rated bonds. The fund can invest 60 percent of its assets in A- and BBB-rated bonds with no issuer being more than 1 percent of the overall portfolio.

Challenge Two: Staying Short

Many investors may have said something along the lines of the following: "I want to keep my maturities short in case interest rates go up. I don't want to get caught in low interest rates."

Currently, the yield curve is exceptionally steep. This means that investors can pick up an additional 0.2 percent to 0.3 percent for each additional year from one to 10 years of maturity. This means investors are giving up a significant amount to stay on the short end of the yield curve.

Another consideration is that the yield curve may not shift parallel, but may see short-term rates rise sharply with longer-term rates remaining near current levels. This would hurt the returns of short-term bonds more than longer-term bonds. (This occurred in 2004–2005, the last time the Federal Reserve raised rates over a prolonged period.)

Challenge Three: Significantly Extending Maturities

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While staying on the very short end of the yield curve may end up being detrimental for investors, the same may be true of extending too far out as well.

We mentioned above that the yield curve is very steep up to about 10 years. However, the yield curve currently flattens out dramatically after 10 years. Investors who purchase bonds with maturities longer than 10 years are taking additional duration risk and may not receive enough incremental yield to justify the additional risk.

In addition, taking more duration risk raises the volatility of the portfolio, which is in direct contrast to the purpose of adding fixed income in the first place. Diversifying with fixed income should lower the volatility, not raise it.

For those still looking for higher returns, the DFA Selectively Hedged Global Fixed Portfolio may be an option. It allows investors to take on currency risk for higher expected returns, but do so in a diversified manner. Another option is the TIAA Traditional Fund, which is a guaranteed fixed annuity available to certain qualified plans. The fund currently has a guaranteed rate of return of 3 percent, but liquidity is subject to some restrictions. (Please contact your advisor for additional information.)

Summary

When interest rates are low, it can be tempting to stretch for additional yield. However, investors should remember the purpose behind fixed income before doing so. If additional returns are needed, they should explore alternatives before acting.

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