Lauterbach Financial Advisors, LLC

Market Insights

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The Risks of Fixed Income Investing

The following discusses the major types of risk a fixed income portfolio incurs.

There are four major risks your fixed income portfolio is exposed to:
- Interest rate risk
- Inflation risk
- Liquidity risk
- Credit risk

Interest Rate Risk

Interest rate risk is the risk that a rise in interest rates causes your bonds' values to fall. Interest rate risk generally increases with maturity, meaning longer-term bonds have substantially more interest rate risk than short-term bonds.

Over the period 1964–2009, the standard deviation of the returns of long-term bonds bears out the presence of heightened interest rate risk as maturity is extended:

Returns of Treasuries, 1964–2009		
	Returns (%)	Standard Deviation (%)
One-Year Treasuries	6.6	3.3
Five-Year Treasuries	7.5	6.5
Long-Term Treasuries	7.9	11.7

Inflation Risk

Inflation risk is the risk that your bond returns will be eroded by inflation. Generally, inflation risk is higher as bond maturity increases. For example, a 30-year Treasury bond might yield 4 percent. If inflation averaged 6 percent per year over the next 30 years, then you would have lost 2 percent per year in real (or net-of-inflation) terms.

However, even short-term bonds can have exposure to inflation risk because historically their returns have barely outpaced inflation, and they are not a perfect hedge of inflation. The only securities that are generally guaranteed to outpace inflation (at least on a pretax basis) are TIPS.

Liquidity Risk

Liquidity risk is generally thought of as the cost of getting out of a position. It does not usually imply a total lack of ability to liquidate a security. Also, all else equal, yields on illiquid bonds are generally higher than yields on liquid bonds.

In general, Treasuries are considered to be the most liquid securities. Investors can move in and out of Treasuries and pay very little in the way of transactions costs. Agencies, municipals and brokered CDs are less liquid, costing about 10 to 20 basis points to liquidate the position.

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Liquidity risk also tends to be correlated with credit risk. So when credit risk is increasing (that is, credit spreads are widening), liquidity risk tends to be increasing as well.

Credit Risk
Historically, U.S. Treasury bonds have been viewed as the only fixed income securities with no credit risk. As a consequence, investing in anything other than U.S. Treasuries means you are taking some amount of credit risk. A rule-of-thumb for the amount of default risk you are taking is the spread on the bond versus Treasury bonds. In fact, one popular (yet simplistic) model is to treat the spread as the one-year probability of that issuer defaulting, so a bond trading at a spread of 1 percent has a 1 percent probability of defaulting over the next year.

This measure is simplistic though because it does not account for expected recovery or any other reasons that the spread could be positive (such as a liquidity premium). Nevertheless, it is a good ballpark measure for the amount of credit risk that the market is pricing in.

In general, we are seeing the following spreads in the fixed income market. These spread levels suggest the credit risk in these securities is not negligible.

	Spread Levels (bps)
Bullet Agencies	20
Build America Bonds	80
Aa Corporates	110

Summary
Fixed income investing involves four principal risks:
- Interest rate risk
- Inflation risk
- Liquidity risk
- Credit risk

Almost all bonds are exposed to interest rate risk and inflation risk, albeit in varying degrees. U.S. Treasuries are the only securities considered to be free of credit risk and are very liquid. To the extent one invests in anything other than U.S. Treasuries, there is some degree of credit risk. The credit spread is a good proxy for the amount of credit risk being priced into the bond. In general, the higher the credit spread, the higher the probability of default.

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