How to Ride on the Roller Coaster of…Bonds?

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The fixed income allocation of a diversified portfolio should be created and viewed to provide capital preservation to counter the volatility of stocks in the portfolio. Yet, despite most attention given to the ups and downs of stocks, bonds have been atypically volatile since the middle of 2013. Following the Federal Reserve signaling the end of its quantitative easing program (QE), the Barclays Aggregate index (AGG), comprising mainly of US Treasuries, finished -2.15% in 2013, up 6% in 2014, and slightly positive 0.48% in 2015. Investment grade corporate bonds, as judged by the iShares Investment Grade Bond ETF (LQD), were -2.5% in 2013, up 8.6% in 2014, and -1.1% in 2015. Despite the fears of rising interest rates, the iShares High Yield Corporate Bond ETF (HYG), rallied in 2013, along with stocks, up 5.75%, 1.90% in 2014, but -5% in 2015. Recently, much attention has been given to price swings in the high yield bond market, given the slowdown in global GDP and the selloff in commodities; at one point the HYG was down 12% in 2016. In addition, low rates have put a strain on investors seeking income, particularly retirees. This has forced traditionally conservative investors to have a higher allocation to stocks, or higher yielding, lower credit quality, bonds. Some investors have been forced to own longer dated maturity bonds to pick up more income and in turn, assume more interest rate risk. What's the fixed income investor to do?

The stock market had a rough 2015, and 2016 has been the worst start to a year for stocks since 2009. Yet, higher quality bonds have rallied. Janet Yellen and the Fed seem like a deer in headlights when asked about the near term path of monetary policy. The Japanese have instituted a negative interest rate policy. Following what many deemed the most telegraphed interest rate hike ever, just two months ago, many now believe the US economy is on the same track as the Japanese. These changes in sentiment have a big impact on the pricing and positioning of bonds. However, what investors need to do is build a better bond portfolio, and understand its purpose is to provide capital preservation.

First, when analyzing the fixed income allocation of a portfolio, investors should group bonds appropriately. High yield bonds, convertible bonds, and even preferred stock, should be classified as equities, not fixed income. In times of market distress, these investment vehicles have proven to behave more like stocks, and can sell off sharply, rather than provide stability, as a fixed income investment should.

Second, be cautious on making credit and interest rate calls. Ladder the portfolio over a ten to twelve year period as opposed to attempting to determine what the Fed may do with interest rates based on every nugget of macroeconomic data, comment a Fed governor may make, or guessing what the rate of inflation may be at a certain point in time. Interest rate risk involves the chance that interest rates rise, which makes existing bonds less attractive relative to when interest rates were lower; of course, if rates decline existing bonds become more valuable as they sport rates higher than the newer, lower rates. Trying to time what the Federal Reserve will do in regard to interest rates has proven to be a fool's game.

Although an important consideration in selection of fixed income is the size of the payouts, capital preservation is critical. As a result, give due consideration to credit. Credit risk is the chance the underlying entity of the bond will default. Stick with A credit rated bonds or better, and if possible, buy bonds that are insured. Owning insured and higher credit rated fixed income offers downside protection if the issuer experiences a period of turmoil. The yields on these bonds will be lower, but the stability will provide protection against the riskier equity portion of the portfolio.

Own different types of bonds over that time period such as treasuries, agencies, municipals, and corporates. Owning all corporate bonds in a portfolio that has an allocation to stocks does not protect against the risk of an earnings recession. However, owning all municipal bonds during a severe recession is risky as well, as the state may become distressed, i.e. Detroit.

Finally, own as much of your fixed income allocation in your retirement accounts as possible. Holding fixed income securities in the IRA allows you to avoid present taxation on that income; the same income in taxable accounts would be taxed at the highest marginal rates. Plus, owning equities in the taxable account allows for more financial planning flexibility such as realizing losses, gifting securities, and providing a step up in cost basis upon death.

The market is filled with many cross-currents right now: Will the Chinese economy fall into recession? Will corporate earnings continued to be mired in a slump? Will stock prices and energy prices continue to move in unison? What will be the outcome of the US Presidential election? What will the Fed do with interest rates? Only the future knows the answers to these questions, yet the market is trying price in the impact of future cash flows based on so many variables.

In a well-diversified portfolio, the allocation to bonds should be the portion of the portfolio that provides a ballast, knowing that that portion offers protection versus the day-to-day volatility of the stock market. Allocating to bonds should not be where investors are taking on risk. That should be left to the stock portion of an investors' portfolios. Stick with high credit quality bonds. Next, diversify across the maturity of the bonds and the types of bonds. Finally, sleep better at night, knowing this portion of the portfolio will help offset the daily movement of the equity allocation!