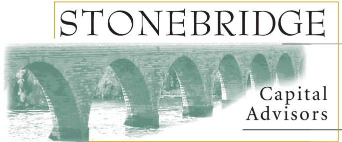
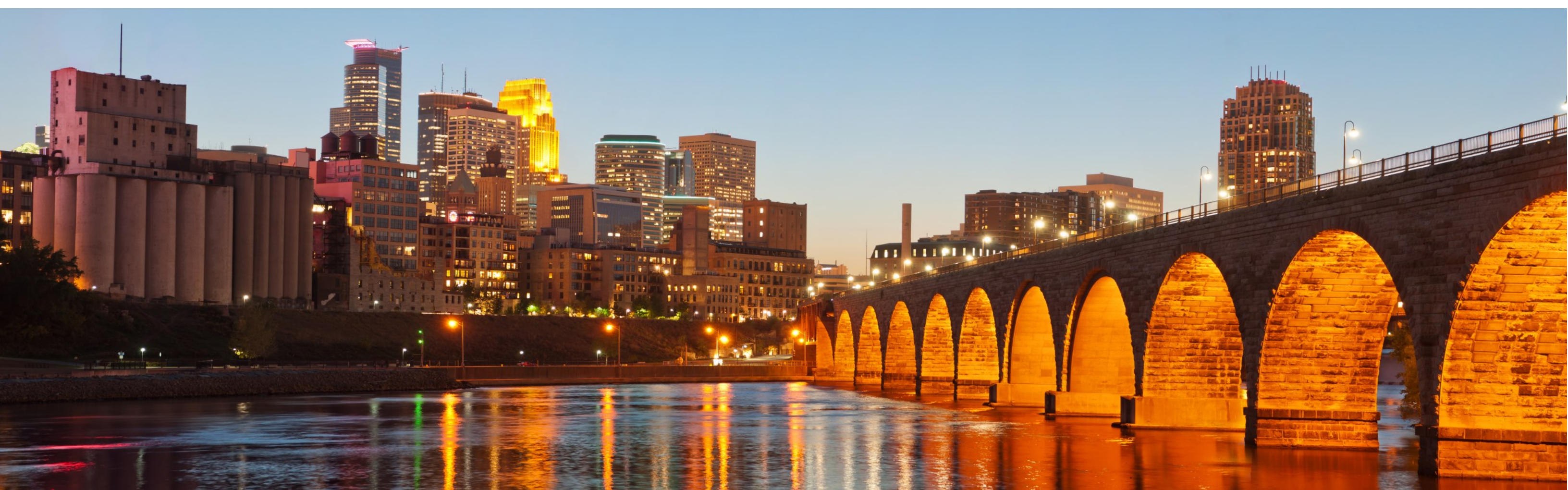


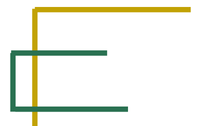
The Bridge Research Article:

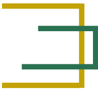
Income vs. Principal

July 18, 2019

By: Scott Shinnick, Fixed Income Trader & Portfolio Manager







Looking At the Current Market

Here at Stonebridge Capital Advisors, monitoring client risk is a continual process. Throughout a market cycle we evaluate what type of risk tolerance each individual client has and compare that to where we believe we are at in a market cycle. We can limit the amount of risk a client's portfolio has by changing the type of investments that they hold. We might look at how different sectors of stocks perform depending on what phase of the market cycle we are in or we may change the allocation of equities to fixed income in order to become more defensive/aggressive. This might not be necessary for all of our clients as they are willing to ride out the ebbs and flows of a cycle, but for many of our clients that are closer to retirement or more risk averse it is a vital part of why they hire Stonebridge in the first place.

As we have stated in several of our previous writings, we are experiencing an extended bull market. The stock market has been on an upward trajectory since the great recession of 2009 and we are at or near all-time highs. This is highlighted in Chart 1 which shows the S&P 500's growth over that time period.

Due to the length of the bull market and some of the signs we are seeing with regards to economic indicators, we have been talking with clients and adjusting their equity allocations where it is appropriate.

Why Own Fixed Income

There are several reasons to hold fixed income:

- Smooth out the highs and lows of a market
- Principal preservation
- Tax advantages of tax-exempt bonds
- Higher priority in claim to corporate assets

While all four of these aspects of fixed income are important, most recently we have focused more on the income and principal preservation when talking with clients.

As Chart 2 shows, yields on the 10 year treasury have decreased since the start of 2019.

While we are not at the historic lows of 2016, it is hard to call these yield levels overly attractive, especially for someone that is using the income generated from their bonds for retirement. That doesn't mean that fixed income cannot play and important role in client accounts. For many of the accounts that hold fixed income we have been recommending that they increase the percentage weight in their portfolios.

Even at these interest rates, the income aspect of fixed income still provides some amount of cash flow. Whether that income is tax exempt or taxable in nature, the cash flow generated helps limit the amount investors must dip into their principal.

Chart 1

Source: Bloomberg

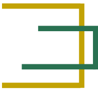


Chart 2

Source: Bloomberg

Another way that increasing the weight in fixed income can protect principle is due to the more defensive nature of bonds compared to stocks. In order to understand why this is the case we should examine how a bond works.

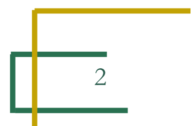
A bond is a loan by an investor to another borrower. This borrower is usually a corporation or a government entity. The interest rate that you earn is based on the length of the loan (the longer the loan the higher the rate) and the credit quality of the entity that you are loaning to (the lower the credit worthiness, the higher the rate). An investor loans money with the intentions of getting paid an interest rate (usually paid out 2 times a year) and their original investment back at maturity.

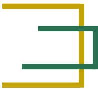
There are several rating agencies that give each bond a quality rating. The two most commonly used rating agencies are Moody's and S&P. Their highest ratings for a bond is known as AAA/Aaa-rated bonds. A bond is of investment grade quality if it is BBB-/Baa3 or better. There are eight rating increments between AAA/Aaa and BBB-/Baa3. The higher the bond is rated, the more likely it is to meet its debt requirements (think of it as a credit score when you try and get a mortgage: the higher the credit score, the more likely the mortgage is going to get paid off). The bonds that have a rating that are less than BBB-/Baa3 are called high yield bonds. They pay higher interest rates because they have a higher chance of the bonds defaulting and the investor getting only a portion of their original investment back.

With that background we can look to see how bonds can preserve principal in a balanced portfolio. When there is a pullback in the equity market, stocks and bonds usually act differently. How much the price of a bond fluctuates is based on the length of maturity and the quality of the bond.

Our current approach at Stonebridge is to look at each individual portfolio and see if there are any gains that we can take to reduce our exposure to equities and reinvest those proceeds into shorter, investment grade bonds. Since these bonds are of higher quality and mature in a short time period, the price of the bonds will not fluctuate as much. Our intention is to hold these bonds until they mature. By doing this, we will get the original investment back in addition to the interest payments that were made while holding the bonds. As these bonds mature, we reevaluate where we are in the market cycle and determine if the proceeds should be reinvested into additional bonds or if the market cycle has changed and we should be reinvesting the proceeds into the equity market.

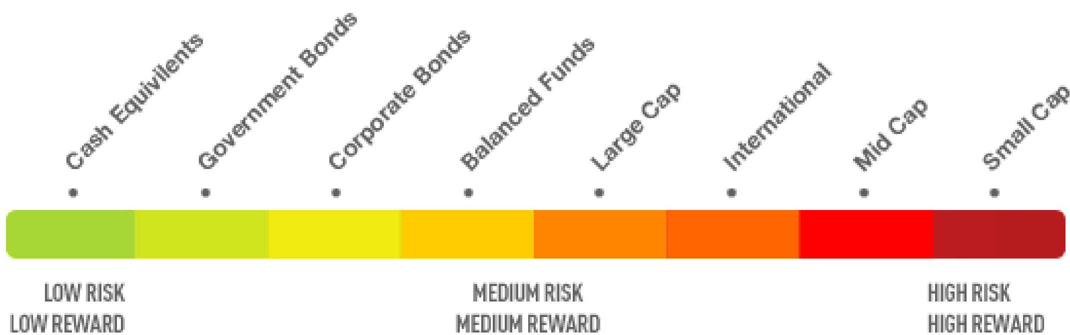
By owning a greater allocation of fixed income in a market pullback, less of the portfolio is exposed to the higher volatility associated with equities. This allows you to preserve more principal and possibly reinvest maturing bonds at a more favorable time in the future.





Conclusion

The graph below shows how stocks and bonds compare regarding risk. Stonebridge mostly focuses on the middle part of the graph which includes large cap equity, balanced accounts (accounts that hold both stocks and bonds) and fixed income accounts (government, municipal and corporate bonds). For balanced accounts, there are ways to lower the risk associated with your portfolio. There are times in a market cycle where adjusting your allocation to have a higher weight to fixed income is prudent. Even at these interest rates, we feel conversations need to occur with clients to make sure they know where we are in the market cycle and to make sure portfolios are aligned with their risk tolerance. Making small adjustments to a portfolio's allocation can have a significate impact on the long-term performance of a portfolio.



Source: EE Bonds Info

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