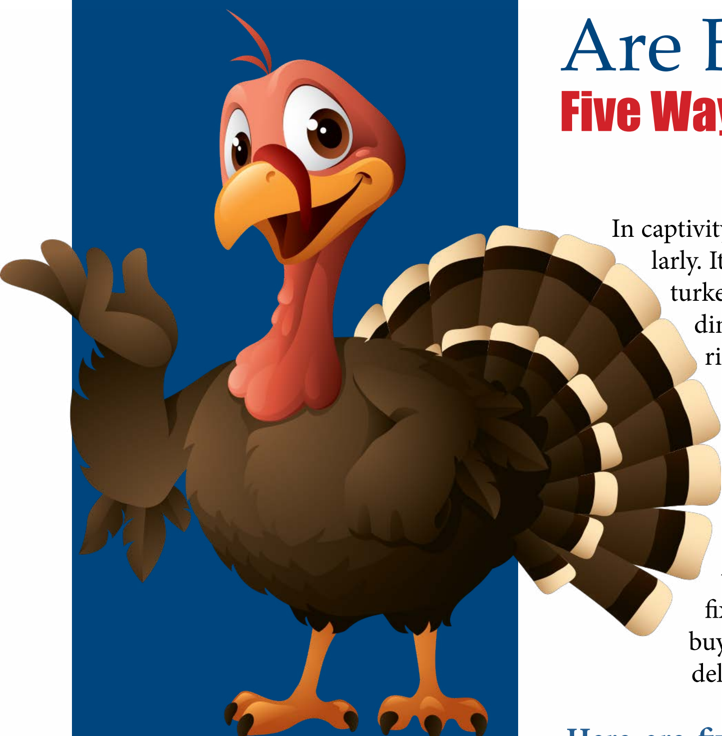
Clark Capital Management Group

NavigatorInsights



Are Bond Investors Turkeys?

Five Ways Investors Can Avoid Getting Cooked

In captivity, a turkey spends its life expecting to be fed well and expecting to be fed regularly. It's a pretty good living – that is, until Thanksgiving draws near. But similar to a turkey that spends its days gobbling up provisions until it becomes someone else's dinner, could bond investors get cooked if they aren't aware of their exposure to risk?

The last 30 years have been kind to fixed income investors. Along with delivering recognizable benefits such as diversification, stability, and income, bonds have also delivered capital appreciation and provided a tailwind to boost investors' equity portfolios. During the last few decades of declining interest rates, fixed income investors haven't needed to be especially selective when it came to the bonds and bond strategies they've bought. For most investors, abandoning fixed income is not an option. However, being more selective about what they buy and having a better understanding of the fixed income environment could help deliver better outcomes.

Here are five ways we believe bond investors can reposition their bond portfolios to navigate risks and capture opportunities in fixed income:

1. **Manage Duration Risk** - Duration measures a bond portfolio's sensitivity to changes in interest rates. In any market environment, duration analysis helps the portfolio manager understand the effects of various portfolio changes such as a rise in interest rates. Duration analysis may help minimize volatility while maximizing total return. In a rising interest rate environment, excess duration risk has been seen to wreak havoc on a portfolio. We took a look at understanding duration in an earlier Navigator Insights. Here is a simple guide to understanding duration.

2. **Consider High Yield Bonds** – When interest rates rise, Treasury bonds typically decline in value. But because high yield bonds have been shown to be negatively correlated to Treasuries and have a high correlation to the equity markets, they may provide better returns in a rising rate environment. In each of the last seven periods when interest rates rose 100 bps or more, high yield bonds posted positive returns while Treasuries were negative. We believe high yield bonds may offer a better risk/return profile than Treasuries in a rising rate environment. However, because of their high correlation to equities, it's important to use an active approach when allocating to high yields. High yields carry more downside risk, and an active strategy can help provide risk management. More on our high yield views in this Navigator Insights.

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Be Flexible - Using actively managed, nontraditional bond strategies may help provide better risk-adjusted returns in a rising rate environment. Since the nontraditional bond category is a relatively new Morningstar category, it's important to do your research before selecting a strategy. Nontraditional bond approaches should have well defined objectives and levels of risk that the portfolio manager will take. Being flexible within one's fixed income allocation is important. For instance, a tactical fixed income manager will compare the benefits of taking duration versus credit risk. It's important for that manager to understand where we are in the business cycle. In our view in good phases of the cycle, it pays to be aggressive; in bad, it pays to be defensive. We believe a flexible approach can add a lot of value in the fixed income space.

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Consider Individual Bonds - An individual bond portfolio held in a separate account could allow the owner to control his or her own destiny. The owner is not affected by other investors' selling or buying activity which is the case in mutual funds. A panicked sell-off in the fixed income markets or a rise in rates would result in a decline in bond prices. It would lower the account value for the individual bond holder. However, if held to maturity, the individual bonds would regain all of their "paper losses" at maturity. More on the differences between owning bond funds and individual bonds here.

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Take an Active Approach - It's important to remember that any investment entails taking risk, and that bonds can in fact lose money. The goal of any investment strategy should be to manage risk and reward. While we may be moving into a period when fixed income returns are diminished, bonds will continue to be used as a portfolio diversification tool and income generation tool. We believe the best way to address the future in fixed income is to take an active approach and utilize a broad set of tools to manage the transition from bull market to bear market in bonds.

Author: Patty Quinn McAuley

Patty Quinn McAuley, CFP®, is the Director of Marketing for Clark Capital Management Group. On the blog, she writes about helping clients achieve successful investment outcomes and about communicating effectively with clients.