Clark Capital MANAGEMENT GROUP

NavigatorInsights

Managing Fixed Income in a Changing Interest Rate Environment

Tired of the constant chatter about where interest rates are headed and what will happen when they finally rise? We've compiled the following five ideas for positioning your clients' bond portfolios to capture opportunities and navigate risks in fixed income — regardless of where rates go.

"Interest rates may go up or may go down. One thing that's for certain is that they will change"

— Jamie Mullen
Clark Capital Senior Portfolio Manager

1. Own Individual Bonds

An individual bond portfolio held in a separate account allows investors more control over the portfolio than a fund. 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.

2. 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 with fixed income is to take an active approach and utilize a broad set of tools to manage changing interest rates and volatility in bonds. Yield curves flatten, rise, fall and twist, and all of these scenarios create opportunities to deliver value above and beyond just the coupon. There are several ways to deliver greater return to the client by being active along the yield curve and maturity spectrum. By being passive, you forego that opportunity.

3. Maintain Flexibility

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.

4. 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 the manager to 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 straightforward guide to understanding duration.

5. Consider High Yield Bonds

When interest rates rise, Treasury bonds typically decline in value. But because high yield bonds historically 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. 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 of our views on high yield in this Navigator Insights.

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