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***Defensive Income Strategies for Rising Rates & Bond Outflow Rotation***

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Most retirees don’t have the risk tolerance for sharp downward volatility in equity markets, nor are many comfortable with the traditional 10-year holding period necessary to recover from another 40% drop in stock indices. Over a hundred million of retirees will be facing a new reality, as another roughly 75 million baby boomers continue to move into the golden years with the expectation of taking less risk and having sufficient portfolio income to sustain their longevity and lifestyle. However, the days of 3-4% CD yields and 6-7% from investment grade corporate bonds are gone and the opportunity frontier for income has sharply narrowed. Also, bonds carry price loss risk in a rising rate environment, particularly if purchased in mutual funds or ETFs.

Perhaps this quandary is one factor that has propelled retirees back into dividend stocks for income, of which we don’t contest the benefits for this allocated part of a retiree’s portfolio. Currently, bonds are experiencing a great rotation, where a substantial amount of money moves from one asset class into another, such as fixed income into equities. In early 2009, we had the reverse, where equity outflows were being redirected into bonds and money markets. A Goldman Sachs report showed over one trillion dollar net inflow into stocks in the four years prior to 2013, which this year is on pace to exceed past years. Although part of the pie is corporate buyback, M&A buyouts and net issuance, the more recent trend has been a focused paradigm shift away from bonds and into equities.[[1]](#footnote-1) Indeed, investors withdrew an estimated $43 billion from taxable bond mutual funds in the month of June alone and when the market sells bonds and buys stocks in large rotational dollar amounts, bonds decline and equities tend to increase. Of course another equity attraction has been the central bank’s balance sheet stimulus and essential zero rate fuel, which has made many investors assume market risk (equity premium) is lower.

Meanwhile, many bonds have already taken it on the chin, as there has been a large adjustment in some bond funds shifting to lower duration after Bernanke rattled the bond market earlier this year. To keep things simple and not considering the different bond grade ratings or convexity, if a mutual fund has an average duration of seven years, if rates were to increase 1%, the bond fund would hypothetically lose 7%. Even while the Fed has not moved rates up or indicated an increase yet this year, the asset class rotation has arguably already started, as the Barclays Aggregate Bond Index declined -2.3% so far this year. The ten year Treasury bond ended the quarter yielding 2.5% compared to 1.7% at year end, translating for mutual funds that own long government bonds averaging over a -7% loss this year. Treasury Inflation Protected Securities lost ‐3.6% in June and were down over ‐6.5% year-to-date. Although International bonds recovered +2.4% in July, they have also suffered, with the Barclays Global Treasury Bond Index being down ‐4.7% this year.

On the professional institutional investor side, there was ample opportunity to sell longer duration bonds trading at a premium over par (higher market price than maturity value) in early 2013. Also, there was an early yield roll down opportunities as a strategy to generate yield and protect principal investment. Rolling down the curve can be accomplished by purchasing of a bond with a maturity in the higher yielding section of the yield curve and selling the bond prior to maturity when it reaches a lower yielding section, assuming a positively and unchanged sloped yield curve. When prevailing interest rates are expected to increase in the future, this motivates investors to “roll down the yield curve” with bonds that are approaching maturity, with the assumption that bonds potentially are valued at lower yields and higher prices. In short, some institutional players moved early and locked in price appreciation well ahead of any prospective interest rate increase by the Fed.

There has been financial articles’ positing that holding investment grade bond mutual funds in a rising rate environment will only lead to short term price fluctuation losses, but in the longer term the mechanisms are in place for stability as these funds simply hold bonds to maturity and buy new higher yielding bonds (assuming rates are increasing). We believe this could be an ongoing market loss scenario for longer maturity funds. Assuming a bond fund is not short-term duration, then in an ongoing rate increase environment the bond fund will continually be a step behind prevailing higher market rates, subjecting the fund to continual bond price erosion on seasoned lower yielding bonds relative to prevailing higher market yielding issuance.

With investment grade bond yields barely high enough to cover inflationary costs of living, what are the income options for retirees? In light of the fact that we are in substantial better economic environment than a few years ago, along with considerably stronger corporate balance sheets, we would suggest one part of the answer is to assume different risk for the bond section of the portfolio, such as high yield bonds and convertible bonds. Both are much further down in the capital structure of a company and offer characteristics to better protect losses in a rising rate environment. Another part of the equation for income would be to choose different sources for yield, such as REITS, MLPs, utility preferred stocks and selling covered calls (often already holding high dividend stocks).

* Although an investor is taking on more credit risk, high yield bonds have delivered returns that exceed other fixed income vehicles and have been shown to have similar returns to equities over the past decade in a half. Also, with the markedly higher coupon to compensate for risk, these bonds are less susceptible to loss from rising rates. The average coupon over the past decade in the half approximates 9% range. In fact, the premium yield spread over treasuries often contract during rising rates, suggesting high yield prices can actually increase in value. Though the optimal approach would to buy dozens of individual bonds, most retail investors don’t have the capital or access to full supply of issuance for diversity and, therefore, they are typically relegated to funds.
  + We would suggest funds that held up in 2008, such as Wells Fargo Advantage Short-Term High Yield Bond (SSTHX, load waived), which only lost 5.8% in 2008’s upheaval. This fund yields almost 4%, is in the positive this year when bonds are largely in the red and has delivered over an annual 4.6% return over the past 10 years. Although ETFs tend to be more volatile than mutual funds, PowerShares Senior Loan Portfolio ETF ([BKLN](http://finance.yahoo.com/q?s=bkln)) is a senior secured loan yielding about 4.3%, but with a much higher recovery in default scenarios; it also is floating rate, which insulated the fund from rising rates.
* Convertible bonds are considered hybrid fixed-income securities that offer income with equity-like exposure, and at times, offer defensive characteristics during periods of rising rates. The fixed income component of convertible bonds is protective since there is a par maturity with the principal repayment feature, along with semiannual coupon payments. Investors give up some coupon yield in return for an option to convert into equity if the issuer’s share price rises above a preset value (e.g. if stock is $50, option could be set at $55). The market size for U.S. convertible bonds is growing again and is now over $200 billion[[2]](#footnote-2), currently yielding in the 3% range with an average BB- (investment grade) rating.
  + Again, we suggest diversity of many individual securities, which would likely limit retail investors to mutual funds and ETFs. Similar in approach to the high yield mutual funds, we look at which convertible funds had the lowest loss exposure during the 2008 capital market sell-off. In this category, we like a fund that uses both low duration corporate and convertible bonds, Greenspring Fund (GRSPX), which only lost -11.7% in 2008. Yet, this fund yields 3.4%, is up 12.9% for the year and has a 10 year annual return over 8%. For ETFs, there is SPDR Barclays Convertible Securities ETF (CWB) that yields about 3.9%.
* Though REITs can be as volatile as equities, this asset class has real property characteristics as an underlying asset and cash flow for income. REITs assets are in real estate to produce income, where at least 90% of its income is distributed back to its shareholders. However, REITs took big hits in 2007 and 2008. The self-storage REITS held up the best in 2008, followed by health care REITS, which were down about 12%. We also like diversified conservative Realty Income Corp (O), which yields about 5%, and has a long history of cash flow and dividends. The REIT has held up reasonably well in periods of market volatility.
* Although MLPs have already experienced a solid run-up this year, during periods of consolidation, this is an attractive asset class to include for income. We like diverse MLPs with healthy yields and find Brookfield Infrastructure (BIP) to be attractive with 4.5% coupon clip on global interests intoll roads, railroads, electricity-transmission grids, pipelines, ports, and timber. Also, the UBS E-TRACS Alerian MLP Infrastructure ETN (NYSE: MLPI) holds 25 largest MLP's related to energy infrastructure sector and currently yields about 4.4%. Stable cash flows, income and unique commodity exposure of diverse MLPs can help mitigate some volatility relative to equity markets.
* Utility preferred stocks and preferred funds are long maturity preferred shares in utilities that have high dividend yields from water, gas and electric, telephone and other infrastructure. These shares provide high yield, “first in line” dividend distribution (before common shares), credit agency ratings, and can often have lower volatility. Again, here we prefer diversity in funds, but a couple attractive individual securities with 5-6% yield range that demonstrate lower volatility are Pacific Gas & Electric Co. (AMEX: PCG) (PCG-A, non callable) and Georgia Power Company (NYSE: GPA) (GPE-A, but callable). For ETFs, high yielding preferred exposure is available through iShares S&P U.S. Preferred Stock Index Fund (PFF), which yields 5.9%. A respectable 6.5% yielding mutual fund in this category is Cohen & Steers’ Preferred Securities and Income fund (CPXIX), which tends to outperform its ETF counterparts and has delivered over 11% annually over the past three years.
* Covered calls earn additional income by selling to another investor the right to buy some of its stock holdings at a set price at some future date. Investors can write covered calls on their own portfolio of stocks for more income, or buy a call option fund that handles these trade strategies. This can be an attractive extra income source for those that believe the market has already logged in most of its gain this year, as we do, and expect more volatility (increasing the value of said option). In this space, we like Gateway Fund (GATEX, load waived), which attempts to “capture a substantial portion of the long-term total return potential of equities, while limiting portfolio volatility to a level similar to that of long-term bonds.” Although it only yields about 1.7%, the income from call writing is in the return, which is up 4.7% this year and about 6% annually over the past three years. The fund also uses put options to limit downside risk. We also like Bridgeway Managed Volatility (BRBPX), as they use covered calls for additional income and as a tool to reduce the risk of ‘outright stock ownership.’ The fund is up 6.4% this year and delivered about 7.8% annually over the past three years. For ETFs, there is Horizons S&P 500 Covered Call ETF (HSPX).

1. *An equity investor’s guide to the Flow of Funds Accounts*, Goldman Sachs, Portfolio Strategy Resource, March 11, 2013. [↑](#footnote-ref-1)
2. *An Overlooked Way To Play This Market: Convertible Bonds*, Forbes Magazine, 5/31/2013. [↑](#footnote-ref-2)