Three Ideas for Positioning Your Fixed Income Portfolio

Given the late cycle and flat curve, these strategies offer investors the potential for increased income and return without adding uncompensated duration or equity-like risks.

Let Bonds Be Bonds: Seek Stability and Diversification

The Federal Reserve (Fed) is currently leaning dovish, but Chairman Powell’s 180-degree change in rhetoric in Q4 2018 should keep investors alert for policy surprises. Uncompensated duration risks may not be ideal. Meanwhile, whipsaw equity volatility juxtaposed with credit spreads 31% below long-term averages, weakening new issuance credit conditions, and credit rating downgrades outpacing upgrades by the most since 2009 mean loading up on equity-like credit exposures alongside overweighing equities may prevent bonds from fulfilling their basic role: providing income, diversification and stability.

The chart below illustrates this tradeoff between bond sectors’ yield per unit of duration, drawdowns and sensitivity to equities. Notably, shorter- and intermediate-term investment-grade bonds have had smaller drawdowns resulting from a better breakeven of yield-to-duration than broad corporates or Treasuries and nearly a zero beta to equities. Conversely, high yield has historically shown higher equity sensitivity, and right now, its correlation to equities is at all-time highs.

How Can Investors Navigate This Theme?

Funds in Focus

- SPDR Portfolio Intermediate Term Corporate Bond ETF (SPIB)
- SPDR DoubleLine Total Return Tactical ETF (TOTL)

No matter how the Fed impacts the short end, the long end of the yield curve is likely to remain constrained by the secular growth and tepid inflation that have pushed term premiums vastly negative and to their lowest level since 1961. Therefore, given late-cycle dynamics that have led to microbursts of volatility and a flat-skewed curve, we favor active and intermediate-duration bond strategies that offer the potential for increased income and return without uncompensated duration or equity-like risks.

Consider Convertibles: Replace Traditional Equities

Despite a 14% rally through the first half of 2019, where the underlying convertible securities outperformed the S&P 500 Index, convertible securities have become more bond-like due to an increase in issuance, a trend that will likely continue. After hitting a post-crisis high of $52.4 billion in 2018, convertible issuance is ahead of that pace, with $25.9 billion through the first half of the year ($52.8 billion annualized).

Firms are issuing more convertible debt because customized financing terms make convertibles attractive late in the cycle, when corporate balance sheet management is vital. Also, all-time equity market highs support better financing terms through the allure of greater price appreciation than with straight corporate debt.

The chart below highlights two variables that have made convertibles more bond-like: average stock delta (the sensitivity of the convertible bond to the underlying stock) and the premium to parity (the value of the underlying equity if the convertible is converted). New issuance that is further out-of-the-money has lower deltas and larger premiums. With new issuance replacing older convertible debt with high deltas and low premiums, broad-based intermediate convertible securities have become more bond-like.

Source: Barclays, 06/30/2019 based on the Bloomberg Barclays US Liquid Convertibles Index.
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**Funds in Focus**
- SPDR Bloomberg Barclays Convertible Securities ETF (CWB)

Their hybrid nature means convertibles have experienced lower volatility and lesser drawdowns than equities over the last 10 years.\(^3\) Their strong returns and more bond-like characteristics can provide a lower-volatility replacement for traditional equities without sacrificing upside participation — all with a yield 49% greater than the S&P 500.\(^10\) The SPDR Barclays Convertible Securities ETF [CWB] is the largest US-listed convertible securities fund, with over $3.8 billion in assets, a gross expense ratio of 0.4% (three times lower than the average expense ratio of the Morningstar Convertibles category) and a four-star Morningstar rating.\(^11\)

**Look at Emerging Market (EM) Debt: Broaden Your Hunt for Yield**

As the Fed struck a dovish tone alongside relaxing US-China trade tensions, the US dollar (USD) fell by 1.5% and EM currencies rallied by 2% in June, reversing yearlong trends. Given that many EM nations peg their currency to the USD and the multitude of debt financing terms in hard currencies, the Fed’s policy change should continue to positively impact EM sentiment.

The significant decline in global interest rates is another tailwind. Beyond the US, rate cut expectations have noticeably increased in the UK, Eurozone, Japan and Australia, raising the quantum of global debt with negative yields to over $12 trillion.\(^12\) This has boosted demand for higher yielding debt to satisfy income needs. Unlike higher income-generating asset classes such as US high yield corporates, EM local debt (EMD) is 80% investment grade,\(^13\) and the majority of its risk and returns can be explained by movements in EM currencies, as shown below.

**Funds in Focus**
- SPDR Bloomberg Barclays Emerging Markets Local Bond (EBND)

EMD may provide a way to pursue a yield north of 5%,\(^14\) move up in quality and diversify away from rate and credit risk in an environment where the Fed’s dovish stance may continue to support EM currencies. The impact of monetary and fiscal policy regimes on EMD makes broad diversification important. EBND seeks to provide broad beta exposure to 20 EM nations, including South Korea and Israel — as well as more than 150 newly added Chinese local bonds (2.5%). Unlike funds that follow the J.P. Morgan GBI-EM Global Core Index, which has a 3% floor on a country’s minimum weight, EBND has no minimums on country allocations.
Endnotes

1 Bloomberg Finance L.P., as of 06/30/2019 based on the 20 year average of the Bloomberg Barclays US Corporate High Yield Index option adjusted spread.

2 Over the past three years, 79% of new issues have been deemed covenant lite, Bank of America 06/30/2019.

3 Bank of America Merrill Lynch, as of 06/20/2019.

4 Bloomberg Finance L.P., as of 06/30/2019 based on 52 week returns versus the Russell 3000 Index.

5 Bloomberg Finance L.P., as of 06/30/2019 based on the Adrian Crump & Moench 10 Year Treasury Term Premium.

6 Based on the Bloomberg Barclays US Liquid Convertibles Index per Bloomberg Finance L.P. as of 06/30/2019.

7 Based on the Bloomberg Barclays US Liquid Convertibles Index per Barclays as of 06/20/2019 with a return on the Underlying Equities of 21.93% versus the S&P 500 Index return of 18.54%.


9 Source: FactSet, as of 12/31/2018.

10 Source: Barclays, 08/20/2019.

11 Morningstar, as of 07/05/2019. There are 81 strategies in the Morningstar Convertibles ETF and Mutual Fund category. The average net expense ratio for the US Convertibles category is 1.21.

12 Bloomberg Finance L.P. as of 06/30/2019.

13 spdrs.com as of 06/20/2019 based upon the Bloomberg Barclays Emerging Markets Local Currency Liquid Government Index using the Bloomberg Barclays Composite Rating, Bloomberg Barclays uses an evenly weighted blend of a security's Moody's, S&P, and Fitch rating rounded down to the lower rating in the case of the composite being between two ratings. In the case where a security has no rating, an issuer rating may be used to determine index classification. Bloomberg Barclays Index breakdowns are grouped into larger categories.

14 Based upon Bloomberg Barclays Emerging Markets Local Currency Liquid Government Index per Bloomberg Finance L.P. as of 06/30/2019.
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A commonly used measure, expressed in years, that measures the sensitivity of the price of a bond or a fixed-income portfolio to changes in interest rates or interest-rate expectations. The greater the duration, the greater the sensitivity to interest rates changes, and vice versa.

J.P. Morgan GBI-EM Global Core Index A fixed-income benchmark that seeks to track the investment results of an index composed of U.S. dollar-denominated, emerging market bonds. (Underlies the ETF “EMB”).

S&P 500 Index A popular benchmark for U.S. large-cap equities that includes 500 companies from leading industries and captures approximately 80% coverage of available market capitalization.

Volatility The tendency of a market index or security to jump around in price. In modern portfolio theory, securities with higher volatility are generally seen as riskier due to higher potential losses.

Yield The income produced by an investment, typically calculated as the interest received annually divided by the investment’s price.

Important Information
Risk Disclosures
Investing involves risk including the risk of loss of principal. Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs’ net asset value. Brokerage commissions and ETF expenses will reduce returns. Investments in mortgage securities are subject to prepayment risk, which can limit the potential for gain during a declining interest rate environment and increase the potential for loss in a rising interest rate environment. The mortgage industry can also be significantly affected by regulatory changes, interest rate movements, home mortgage demand, refinancing activity, and residential delinquency trends. Non-diversified funds that focus on a relatively small number of securities tend to be more volatile than diversified funds and the market as a whole.

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