Fixed Income Allocations in a Rising Interest Rate Environment

Fixed Income (Bonds) is the Swiss Army knife of the investment portfolio - adaptable to many different situations and able to be configured in a variety of different ways. Their role is to be reliable sources of income and to provide a locus of stability that can enable other portions of the portfolio to take on additional risk while keeping overall portfolio risk within expected ranges. Investors have enjoyed a generations-long secular bull market in bonds as yields have declined from the highs of the early 1980s until today. Unlike stocks, bond returns arise almost exclusively from income over long periods of time, and with current income levels of 2-2.5% on the benchmark 10-year US Treasury, bond returns on a prospective basis are likewise constrained.

Thus, the dilemma that faces investors as they assess the merits of a low-return asset class:

- Are the roles of income generation and stability enhancement that bonds play in a portfolio still valid?
- Is there an asset class that can substitute for the combination of income generation and volatility dampening?

Providing Income and Protecting Principal – Still the Case?

Bond math is comfortingly inexorable – when yields go up, bond prices go down and the longer the bond maturity the more the price will vary for a given change in yields for bonds of similar coupons. The risk of large losses due to a change in the interest rate environment for traditional intermediate maturity holdings is substantially dampened by the support of the coupon payment. Very long maturity bonds with low coupons will have more price volatility, but are not commonplace for most investors. The above chart demonstrates that historically, while bond returns can be negative for a one year period of time, there have been no instances of multi-year negative returns and in fact any periods of negative return have been recouped within the next years’ experience. The data supports the use of bonds as a source of stability within a portfolio, albeit with very low return expectations at today’s low yields.

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1 The concept of “duration” measures the point at which the return from current income balances the amount paid for a bond purchases – and the longer the duration of a bond, the more price risk for a given change in interest rates. For example, a ten year zero coupon bond has a duration of 10 –because no cash flows return to the purchaser until the bond matures. A ten year bond with a coupon of 5% bought at par has a duration of 8 years, which is the point in time at which the coupon payments plus the income earned from the reinvestment of those coupon payments equal the price originally paid by the investor to purchase the bond.
Individual bonds can be held to maturity, they will pay 100 cents on the dollar at maturity; there may be an opportunity cost if rates rise after the purchase of an individual bond, but when held to maturity and if purchased at or below par, there should be no realized loss. Since individual bonds can be difficult to purchase for many investors due to the frictional drag of transaction and diversification costs, bond mutual funds have become the default mechanism for providing fixed income returns. While not having a specific maturity date, bond funds can contain a variety of maturities, durations and credit exposures. Careful selection of a mutual fund can provide many of the same risk buffers as high quality individual bonds for overall portfolio management needs.

**What Lies Ahead?**

Of course, the question of greatest interest is the future path of interest rates. The chart above provides a 30 year perspective on the decline of rates since the mid 1980’s, from levels of 9%+ to the recent low yield of 1.6%. The decline in interest rates has arguably been the most important factor driving US financial market returns on a secular basis for a generation, and the question facing investors today is whether that decline has come to an end. The Federal Reserve has raised short-term rates twice already in 2017, and likely will do so again.

In a normally expanding economy, rising short-term rates, which are somewhat within the control of the Fed, frequently anticipate rising longer-term rates, with the distribution of rates from short maturities of 3-6 months to longer dated maturities of 20-30 years being referred to as the “yield curve.” Longer-term interest rates are not set by the Federal Reserve, rather they are set by market forces of supply and demand as investors buy and sell bonds in and out of investment or trading portfolios. The unique aspect of the present cycle has been the activity of the Federal Reserve since 2010, when policymakers decided to pursue a strategy known as “Quantitative Easing” in the hopes of driving a lackluster GDP trajectory to a higher path. “QE” became the term used to describe the Federal Reserve purchasing bonds in the marketplace (in the US, purchases were limited to Treasuries and Agency mortgage securities) in an effort to affect not only the short end of the yield curve through the traditional mechanism of setting short-term rates, but also the longer end of the yield curve by altering the supply and demand dynamics in a manner that supported higher bond prices (meaning lower bond yields) than would otherwise be the case. With interest rates thus suppressed along the entire yield curve, the cost of financing new economic activity was reduced and higher levels of investment and activity should have resulted. The outcome over the past seven years has been mixed, with overall GDP and employment growth remaining stubbornly modest even in the face of historically low interest rates. Excess capacity in the economy and workforce has gradually been reduced and the economy is now at the point at which the Fed is prepared to remove some of the unique supports that have been in place for the past seven plus years.

We do not know how the economy will respond to an increase in rates and whether the somewhat stronger levels of economic activity we are measuring today will endure in a higher rate environment. The new administration may bring with it a renewed interest in fiscal spending, which may be financed by additional government borrowing and could lead to higher interest rates and inflation measures, if such programs can be agreed upon and implemented. Neither the agreement nor the implementation is certain. The breadth of the potential outcomes for the intermediate future is surprising wide, and with such a wide range of future scenarios we are acutely aware of the benefits of diversification. Portfolios should include assets that can preserve value in difficult environments as well as assets that can provide growth and income in more hospitable times. Transparency and liquidity should be the hallmark of most positions, while some investors may be able to accept illiquidity in exchange for premium returns.

There are several forms of diversification available to the long-term investor: between asset classes (i.e. a mix of stocks, bonds, cash, and alternative investments) and within asset classes (i.e. Equity style categories, differing bond categories). Both are important, but for the balance of the current discussion we will focus on diversification within the fixed income portfolio itself and some proposed bond substitutes.

We should first outline the factors that determine bond prices across different types of bond investments. The impact of interest rates is well known; the overall level of interest rates is the primary driver of most investment grade bond prices. The coupon structure is a related topic, with low-coupon bonds generally experiencing larger price swings for a given change in interest rates than higher coupon offerings. Generally, the lower the coupon rate, the higher the duration for bonds of similar maturity. Credit risk is usually the next most influential determinant of pricing, with corporate bonds trading at interest rate spreads to similar duration US treasuries based on the market’s perception of their creditworthiness. For corporate bond investors, the additional spread in interest rates can sometimes overcome price changes triggered by shifts in the overall interest rate environment if the cushion is sufficiently plump. Alongside credit concerns, for non-US bonds denominated in local currencies, exchange rate concerns are a factor, with non-dollar denominated bonds reflecting the market’s opinion of the likely path of relative currency values over the course of the bond interest and principal payment lifespan in addition to credit considerations. The liquidity profile of bond investments can vary significantly by type as well, with US Treasury bonds typically offering superior liquidity to other offerings, especially in periods of market turmoil. Liquidity, or the ability to trade a position without experiencing substantial
frictional transaction costs, only becomes important when an investor needs to buy or sell a position – at which time it becomes of paramount importance.

Non-investment grade (high yield) bonds have also earned a place in many institutional portfolios, owing to their generous yield premiums and generally acceptable risk profiles. Many investors view high yield bonds as an asset class that combines some of the risk profile of a fixed income instrument with some of the return profile of an equity investment, as high yield bond prices will frequently correlate with the stock price of the underlying company. High yield bond spreads can be very sensitive to market dynamics however, and trading liquidity can rapidly become problematic during periods of overall market stress or in the face of company-specific concerns. Diversification between credits and a careful selection process of credit exposures is especially important for the high yield portion of a fixed income portfolio.

It quickly becomes apparent that fixed income portfolio diversification offers a number of tools to mitigate an increasing interest rate environment via the selection of different classes of bond investments, notwithstanding the fact that diversification away from the traditional government bonds and high quality corporate bond portfolio brings additional risk factors to the portfolio.

The following chart shows the performance of several different fixed income categories during specific rising interest rate environments (defined as increases in the yield of the 10 year US Treasury interest rate) that we believe most resemble the current economic environment. The analysis goes back as far as the late 1980’s and predates the 1990/91 recession. This chart shows the total cumulative returns during each period of rate increase, starting with the first significant period beginning in 1993. The bars are labeled by the first month in which rate increases began. Over all time periods on average, corporate credits, non-US dollar bonds and high yield bonds delivered overall high returns, but the results vary tremendously from one period to the next. The data strongly suggests a diversified approach as adding value to the so-called “lower risk” pure US Treasury portfolio, even though the diversified portfolio brings with it risks relating to credit, liquidity, coupon, and potentially currency exposures.

Source: Strategas

**Fixed Income Returns During Rising Interest Rates**

<table>
<thead>
<tr>
<th>Barclays EM Local Currency Government</th>
<th>Barclays U.S. Corporate High Yield (Capped)</th>
<th>Barclays U.S. Corporate Investment Grade</th>
<th>Barclays 1-5 Yr Gov/Credit</th>
<th>Barclays U.S. Aggregate</th>
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First Month of Interest Rate Increase

**Are There Bond Alternatives to Provide Income and Stability?**

As interest rates have declined, investors have searched for other investment solutions to replace the risk mitigation and income streams that bonds have provided in the past. Some interesting and useful vehicles have emerged that can play a role in a diversified portfolio, but there is no perfect solution. Following the 2008-2009 financial crisis some investors pursued the possibilities in the Alternative Investment realm, where hedge funds can apply a number of strategies to provide Absolute Return vehicles that strive to produce low volatility and consistently positive return patterns. The experience has been mixed as the high imbedded fees from alternative vehicles and competitive financial markets have resulted in returns that are broadly disappointing. In late 2016, as interest rates rose, alternative vehicles did provide some downside buffer during a period when bond market returns were briefly negative, so it remains to be seen if the alternatives allocation will prove to meet its intended goals. For most investors however, alternatives are not an appealing choice to replace the role of bonds.
Not only are many alternative structures only available to the largest institutional investors (due to regulatory requirements), but Alternative strategies for the most part are illiquid and do not provide the easy access to ready cash that a traditional fixed income holding can provide even in the midst of market uncertainty. As well, while some alternatives are intended to provide stability to a portfolio, they do not provide the levels of income that a bond portfolio has traditionally made available. That said, an allocation to Alternatives can substitute for a portion of the “risk mitigation” segment of a balanced portfolio as long as the differences in the return profile, income structure and liquidity structure are fully incorporated in overall portfolio planning.

High yielding stocks and high yield bonds can take on some of the income generation responsibilities in a diversified portfolio previously borne by the bond allocation, with the added appeal that high quality high yield equities may offer dividend growth over time in addition to current income. Investors have pursued traditional high yielding equities such as utilities and REITs (Real Estate Investment Trusts) in the hopes of boosting portfolio cashflow. Such strategies are reasonable within the context of a diversified portfolio with the caveat that, as investors pursue higher yielding stocks, the price of those stocks can rise above the level of their long term fair value and create price risk when investor interest in the yield strategies diminish and interest rates begin to rise. While some investors have allocated away from bonds to increase income levels, to the extent they do so they lose the price stability of bonds and expose their portfolios to higher levels of overall volatility. Some high dividend yield equity funds will concentrate their investments in certain economic sectors that are generally marked by high dividend yielding stocks – which can lead to a deterioration in diversification benefits. High yielding equity allocations should be thoughtfully analyzed to avoid undue concentrations, which can result in performance volatility during difficult market environments.

Traditionally High Yielding Equity Sector Stock Prices are Influenced By Interest Rates

The bottom line is that no ideal substitute for fixed income positions is forthcoming, and investors are faced with the dilemma of accepting very low returns in exchange for a highly certain return of principal. While frustrating, our view is that most investors should consider holding a portion of their portfolio in fixed income in light of the stability, liquidity, and transparency that the asset class can provide. Although actions can be taken around the margin to boost return, one role of the bond allocation should remain that of portfolio stabilizer to hedge against periods of future market uncertainty. The chart below demonstrates that, on average, a diversified portfolio holds up better than a pure bond portfolio during periods of increasing rates (again, as defined by increases in the 10 year UST yield). However, there is marked variability between time periods and asset classes, which offers an important reminder as to the benefits of overall portfolio diversification and the impact of an “all-weather” portfolio.
As long term pools of capital continue to move toward a total return approach for portfolio investing from that of an income only strategy, our recommendation is that today is an opportune time to position allocations in advance of a rising rate environment. If the focus is purely income, then consider diversifying within fixed income. For those where total return is the primary driver, committees can look to improve risk adjusted returns by investing in other asset classes prescribed by their investment policy with the understanding that such allocations are not perfect substitutes. As with many things, moderation and balance are the keys to long term investment success in an environment marked by shifting currents and evolving expectations.

### Making Fixed Income Allocations Work: A Call to Action

Nonprofit organizations with upwards of a third or more of their investments in core bonds must be thoughtful about the purpose that fixed income is expected to serve. It is best when, at least once annually, investment committees affirm that the risk profile described within the Investment Policy Statement makes sense for the organization. We believe that there are ways to mitigate downside risk and still generate meaningful portfolio returns, by diversifying within fixed income or reallocating in part from fixed income into other investment categories. As fall and the next fiscal year planning season approach, it is a great time to add fixed income allocations to the agenda for your next committee and/or board investment discussion.

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\(^1\) March 31, 2017

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