Your Income Portfolio: Better with Balance

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One of the biggest challenges for bond investors today is keeping income flowing without taking too much risk. We think a balanced barbell approach can help.

In a recent post, we explained why now may be the time for bond investors to consider pairing their interest rate–sensitive bonds and credit assets in a single portfolio. We noted that this approach, known as a credit barbell, can minimize large drawdowns while still providing a strong and steady stream of income.

In this post, we'll take a closer look at what makes this strategy tick.

IT'S ALL ABOUT THE INCOME

Let's start with what bonds do best: generate income.

Bond returns come from two places: capital appreciation (measured by the changes in bond prices) and coupon income (semiannual fixed interest payments to bondholders). Over the long run, though, it's the income that dominates.

That's not a big surprise when it comes to credit assets such as high-yield bonds or bank loans. It's these assets' high yields and income potential that make investors willing to shoulder the risk of a ratings downgrade or default.

But between 1997 and 2016, income also accounted for nearly all the average quarterly return of US Treasuries—a purely interest rate–related asset—even though rates fell sharply and prices rose over that period.

This illustrates why rate-sensitive assets should always have a seat at the asset-allocation table. It also helps to explain why a skilled active manager who pairs them with return-seeking assets such as high yield and adjusts the balance as needed has the potential to produce relatively high returns.

NEGATIVE CORRELATION: AN INVESTOR'S BEST FRIEND

But what about the other benefit of the barbell: lower risk? This has to do with the way each type of bond behaves. Government bonds and other risk-reducing assets and return-seeking assets such as high-yield corporates usually take turns outperforming the other.

For example, faster growth tends to feed inflation and push up interest rates, which erodes the purchasing power—and market value—of government bonds. But it can boost consumer spending and corporate profits—good news for high-yield bonds because it lowers the odds of default.

Because these assets tend to take turns outperforming each other, investors can sell the outperformers on one side and buy the underperforming bonds on the other. That limits drawdown risk. In other words, a portfolio that combines high-quality and high-income bonds in a balanced way has the potential to weather most markets.

SURVIVING IN STORMY WEATHER

There are times, of course, when returns for both groups of assets rise and fall simultaneously. These periods don't last that long, and over the last 20 years, returns rose together more often than they fell.

Even so, it can be highly stressful when both take a hit at the same time, largely because it's hard to know which way to lean.

Consider investors' dilemma in 2013, when the "taper tantrum" caused both sides of the barbell to sell off. Did the Federal Reserve's plans to start winding down its monthly asset purchases mean the postcrisis economy was strong enough to get on without them (good for credit)? Or would it bring on a new recession (good for rates)?

The biggest mistake investors or their managers can make in these situations is to sell both types of assets and lock in losses. But when investors entrust their rate-sensitive and growth-sensitive assets to separate managers working on separate platforms, that's a real risk, because each set of managers will be focused on one type of risk.

Like any strategy, a credit barbell can lose money in down markets and correlated sell-offs. But we think it stands a better chance of minimizing damage and positioning a portfolio to rebound when correlations turn negative again.

We'll delve more deeply into barbell construction in another post. But it's clear to us that a balanced strategy gives investors a better chance of meeting their income objectives without exposing them to too much risk.

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