Fixed Income: Solutions for a Low Yield World

One of the biggest surprises of 2014 and the start of 2015 has been the unrelenting decline in global interest rates. Driven by the combination of weak economic growth and unprecedented central bank accommodation, interest rates have collapsed to all-time lows in most of the developed world. In fact, the U.S. 10-year Treasury has dropped below a 2% yield again this year, but even this rate looks like a steal relative to other markets like Germany and Japan where 10-year bond investors are getting paid less than 0.5%. For conservative investors who depend on the income and safety of high-quality bonds, the broad decline in interest rates has introduced a great challenge. While the natural inclination might be to do whatever it takes to replicate the income stream of old, we believe some caution is warranted before extending duration and/or sacrificing credit quality in order to achieve this goal. In our view, there are other ways to tackle the challenge posed by low interest rates that will better preserve capital when interest rates or credit defaults rise. In this month's MAInsights, we will highlight certain strategies that we believe can enhance fixed income returns without creating undue risk for conservative investors.

Fixed to Float Preferred Securities

Primarily issued by financial institutions, fixed-to-float preferred securities offer a unique combination of above-market yields and protection from rising interest rates. While traditional preferred securities, with their fixed coupon payments and perpetual durations, carry significant principal risk when interest rates rise, we believe these new generation fixed-to-float preferreds largely eliminate this risk. Instead of a fixed-for-life coupon, these securities offer a fixed coupon for a finite number of years (typically 5-10 years) and then are either called by the issuer or they convert to a floating rate coupon that resets quarterly based on a pre-determined spread over the prevailing market interest rate (LIBOR). As long as the spread over LIBOR is large enough (we target 3-5%), we believe investors will be adequately protected in a rising rate environment.

As an example, Wells Fargo issued a fixed-to-float preferred in 2008 that pays a 7.98% coupon until March 2018, at which time they will either call it from investors at par, or it will remain outstanding and convert to a floating rate coupon of 3.77% over 3-month LIBOR. At the current price of $109.88, this preferred offers an annualized yield-to-call of 4.47% to March 2018. For comparison purposes, a Wells Fargo senior bond maturing in January 2018 is currently yielding just 1.45%. Although preferred holders are subordinated to senior bondholders in company's capital structure, in our view, the significant yield advantage and the fact that preferred income is taxed at the more favorable "qualified dividend" rate, together offer more than enough compensation for taking on slightly more credit risk in the preferred. On the back end, if Wells Fargo does not call this security in 2018, investors will earn a floating rate coupon of 3-month LIBOR plus 3.77%, which would total 4.03% based on today's LIBOR level of 26 bps. Once the floating rate is in effect, the coupon payment will automatically adjust on a quarterly basis to reflect changes in the market rate (LIBOR), thereby protecting investors from the risk of rising rates. The combination of attractive upfront yield and back-end floating rate protection make us eager to use fixed-to-float preferred securities as a supplement to our core bond portfolios.

Municipal Kicker Bonds

While tax hikes in recent years have made all tax-free municipal bonds that much more valuable, we are particularly favorable on municipal “kicker” bonds. Kicker bonds can be distinguished from traditional bonds by an above-market coupon and a short-term call feature. Because of their high coupons, kicker bonds generally trade at a large premium to par value in the market. On a yield to call and yield to maturity basis, however, these kicker bonds often produce significantly more yield than a traditional bond because of the added duration uncertainty introduced by the call feature.

As an example, the Cleveland Clinic issues a AA-rated revenue bond in 2009 that pays a 5% annual coupon, matures in 2026, and has an optional call in January 2019. This bond is currently trading in the market at a 1.90% yield to the call in 2019 and a 3.71% yield to maturity in 2026. The higher yield to maturity is only realized if the Cleveland Clinic decides not to call the issue in 2019, in which case the yield “kicks” up to the higher rate. For comparison purposes, the average AA municipal bond that matures in January 2019 is currently yielding just 1.05% and the average AA municipal bond that matures in 2026 yields just 2.42%. For clients who own a diversified portfolio of bonds with laddered maturities, we are less concerned with whether the bond is called or goes to maturity, so we can focus more on the yield advantage at both durations. In this case, the kicker bond offers 85 basis points more yield to the 2018 call and 129 basis points more yield to the 2028 maturity than the average AA bond. In the context of an extremely low rate environment, the additional yield realized in kicker bonds can add considerable value over time.

Other Strategies

In addition to the two strategies highlighted above, we are also favorable on certain short duration bond funds and, where appropriate, structured notes that offer an income component. One of the byproducts of the lack of return in traditional fixed income has been the emergence of the "unconstrained" bond manager who has the mandate to earn positive returns regardless of movements in interest rates. Although an extra level of due diligence is required on these new funds, we have identified certain organizations, such as Blackrock and Goldman Sachs, as having the talent and resources necessary to preserve capital if and when interest rates move higher. We also continue to employ Templeton as our preferred global bond manager due to their proven expertise in selecting outperforming credits and currencies over time. The common themes among all these funds are above-market yields and below-market durations, both of which are valuable in today's environment.

Lastly, in certain cases, we have utilized structured notes as a means of generating income based on the movement of an equity index rather than the bond market. These income structured notes are typically issued with 2-3 year maturities and an automatic call feature that is triggered if the underlying equity index is above its initial value one year later or at any subsequent observation date (typically every 6 months until maturity). For example, Credit Suisse Bank issued a structured note in December 2013 with a 30 month term and a 9.85% annualized coupon if the Emerging Market ETF ("EEM") traded above its initial value after 12 months, 18 months, or 30 months. If in the unlikely scenario EEM trades below the initial value in all of these time periods, the investor will earn the return of EEM, but with the added benefit of complete principal protection on the first 15% of the downside. While these structured notes are a bit more complicated than traditional investments, we believe the yield potential (in this case, 9.85% annualized) and the downside protection offered in these notes provides an attractive risk/reward for a portion of a diversified bond portfolio.

While the strategies highlighted above are by no means all-inclusive, we hope they have provided a window into how we are navigating through this challenging fixed income market. We will continue to pursue new strategies than can add value to a traditional bond portfolio either through enhanced returns and/or reduced risk.