STAY THE COURSE OR TAKE A TACTICAL APPROACH TO FIXED INCOME

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While investors may be prone to react to the last "expert" they heard and follow the pack, many advisors generally advise their clients to "stay the course." Yet these same advisors are constantly on the lookout for more productive ways to navigate today's treacherous investment waters for their clients, especially in the bond market. Many advisors realize that we are currently experiencing a unique risk setting with respect to the bond market; the confluence of a bear bond market, potentially imminent rising rates and uncertain Fed policy decisions. Many advisors seem to be looking for what their pre-retiree and retiree clients really need ... strategies that have the potential to deliver:

1) Capital preservation in today's threatening environment

2) Capital appreciation to maintain purchasing power and avoid running out of retirement funds

3) A continuing flow of income when needed.

A weakness of the guidance to manage a bond meltdown, for the investor or planner, is treating the "bond market" as a single homogeneous asset class. The assumption is that all bonds react essentially the same way to economic forces such as interest rates, with maturity and duration being meaningful differentiators. This approach makes the news easier to communicate given the limits of TV time and print space. Unfortunately, it leaves out other vital factors.

Just as many equities (e.g. growth, value, large, small, domestic, international) and commodities (e.g. agricultural, minerals, financials, energy, gold) react differently to economic stimuli, bonds are also not all alike. Each bond class reacts in its own way to those stimuli. Interest rate changes are the primary, though not only, factor affecting values of highly rated bonds, such as U.S. Treasuries and AAA rated corporate bonds. The bond market rarely moves in a straight line up or down. Those with experience and an understanding of market indicators will be on the lookout for the "right bond at the right time" to try to take advantage of trading opportunities. The values of lower rated bond classes may be significantly affected by business factors, and less so by interest rate changes.

As the table below shows, interest rate changes may have a relatively low effect on the value of High Yield bonds, yet credit ratings of the issuing companies have a significant effect. The opposite tends to hold for long term U.S. Treasury bonds.

Bond Sector Risks

Bond Sector	Credit Risk	Interest Rate Risk	Currency Risk
U.S. High Yield	High	Low	None
U.S. Long Term Treasury	None	High	None
U.S. Investment Grade Corporate	Low	High	None
U.S. Municipal	Low	High	None
Emerging Market Debt	High	Low	High
Developed International Market	Low	Medium	High

potentially profiting from a bond investment strategy. The pundits and media folks usually ignore these differences, probably because they are not as easy to understand or as exciting as forecasting a bust in bond prices. But for an investor, these differences may be crucial to managing risk and maximizing returns. When perceived risk increases in one bond class, there is often opportunity in another.

As the following table demonstrates, there have been many periods when U.S. Government bonds have had low or negative returns, while High Yield bonds have had higher, positive total returns. The reverse also appears to be evident.

Total Annual Returns of Two Popular Bond Fund Sectors
January 1, 1998 through December 31, 2017

Year	Domestic High Yield Bond Sector[1]	U.S. Long-Term Government Bond Sector[2]
1998	1.87	9.85
1999	2.39	-2.23
2000	-5.86	13.24
2001	5.28	7.23
2002	-1.41	11.50
2003	28.97	2.36
2004	11.13	3.48
2005	2.74	2.65
2006	11.85	3.48
2007	1.87	8.66
2008	-26.16	12.39
2009	58.21	-2.20
2010	15.12	5.52
2011	4.98	9.02
2012	15.81	2.02
2013	7.44	-2.60
2014	2.45	4.92
2015	-4.47	0.86
2016	17.13	1.05
2017	7.50	2.30

Moving between different bond classes at the appropriate time may help manage risk in a bond portfolio, as well as seek the returns that "baby boomers" and others need. While the economy continues to recover and interest rates continue to rise, the question often raised is how a bond strategy may be structured to potentially grow. This goes to the core of the "bond bust" argument because we have seen U.S. Government bonds lose value at different times. Recall, however, that credit risk is a prime driver of High Yield bond values. Part of the definition of an economic recovery involves business improving, and with it, the credit quality of corporate debt. As a result, during economic recoveries, High Yield bond prices have historically outperformed U. S. Government bond prices.

Take a look at how High Yield bonds, the S&P 500, and U.S. Government bonds have performed in some recovery periods after major recessions.

Average Annual Returns for 3 Years after Recession End[3]			
	High Yield Bonds[4]	S&P 500 TR[5]	BBgBarc U.S. Govt. TR[6]
Recession of 1973	15.48%	6.88%	7.23%
Recession of 1980	14.42%	15.99%	11.73%
Recession of 1981	13.91%	18.60%	13.57%
Recession of 1990	20.24%	9.09%	9.11%
Recession of 2001	10.58%	2.74%	5.08%
Recession of 2007	14.04%	16.40%	5.65%
Average[7]	14.78%	11.62%	8.73%

Rising Rates' Impact on Bonds

The question becomes how much market value can bonds lose if rates rise? This depends on the bonds duration or price sensitivity to changes in interest rates. This table illustrates the anticipated loss in market value in a rising interest rate environment. The longer the bond's duration, the greater the risk of loss if rates move up. Bond investors, especially those holding longer maturity bonds, may see increasing losses in a rising rate environment.

Change in Interest Rates					
Duration (years)	**1%**	**2%**	**3%**	**4%**	**5%**
2	-2.0%	-4.0%	-6.0%	-8.0%	-10.0%
3	-3.0%	-6.0%	-9.0%	-12.0%	-15.0%
4	-4.0%	-8.0%	-12.0%	-16.0%	-20.0%
5	-5.0%	-10.0%	-15.0%	-20.0%	-25.0%
6	-6.0%	-12.0%	-18.0%	-24.0%	-30.0%
7	-7.0%	-14.0%	-21.0%	-28.0%	-35.0%
8	-8.0%	-16.0%	-24.0%	-32.0%	-40.0%
9	-9.0%	-18.0%	-27.0%	-36.0%	-45.0%
10	-10.0%	-20.0%	-30.0%	-40.0%	-50.0%

Source: Forbes.com

Time for a Tactical Approach to Bonds

Investors and advisors alike may be increasingly concerned about the effect that higher interest rates and expanding federal and municipal debt could have on medium and long term bond prices. Holding long term bonds in the years ahead may suggest enduring volatility and loss of capital, especially at a time when investors may still be trying to recover from the market crash of 2008-09. The prospect of this happening has resulted in some investors keeping their money on the sidelines, unsure of what lies ahead. If interest rates eventually move higher, it seems plausible that monetary policy rates could return to a normalization level (closer to the average of 4% as opposed to today's 0.50-.75%). Note that a near-zero rate Fed policy stance is still historically low and these types of events put us in uncharted territory. We may experience an unprecedented series of events in the years to come, a by-product of our recent Great Recession, slow recovery and bear market in bonds. How then may advisors prepare for this and take advantage of the differing performance of the various bond sectors for their clients in varying economic and market conditions?

Today's environment calls for a tactical approach to bonds with the ability to move between bond asset classes based on economic indicators and market opportunities. The potential discrepancy in results among bond asset classes may be more pronounced than we have seen in the past 30 years which, in our view, creates opportunity for a more tactical approach. Now may be the time for a tactical approach to the bond market.

1. Bloomberg Barclays US Corporate High Yield Total Return USD updated through 12-31-17. The U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.
2. Bloomberg Barclays US Government Bond Index updated through 12-31-17. The U.S. Government Index is comprised of the U.S. Treasury and U.S. Agency Indices. The U.S. Government Index includes Treasuries (public obligations of the U.S. Treasury that have remaining maturities of more than one year) and U.S. agency debentures (publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The U.S. Government Index is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.
3. Recession of 1973 defined as November 1973 through March 1975 and 3-year annual return calculated from April 1975 through March 1978. Recession of 1980 defined as January 1980 through July 1980 and 3-year annual return calculated from August 1980 through July 1983. Recession of 1981 defined as July 1981 through November 1982 and 3-year annual return calculated from December 1982 through November 1985. Recession of 1990 defined as July 1990 through March 1991 and 3-year annual return calculated from April 1991 through March 1994. Recession of 2001 defined as March 2001 through November 2001 and 3-year annual return calculated from December 2001 through November 2004. Recession of 2007 defined as December 2007 through June 2009 and 3-year annual return calculated from July 2009 through June 2012. Recession date source: National Bureau of Economic Research website: www.nber.org.
4. High Yield Bonds: An equally-weighted portfolio of the 6 high yield mutual funds that existed on 4/1/75, rebalanced monthly. The funds are Eaton Vance Income Fund of Boston A, First Investors Fund for Income A, Franklin High Income A, Lord Abbett Bond--Debenture A, Northeast Investors, and Wells Fargo Advantage High Yield Bond B. Performance includes reinvestment of dividends and capital gains.
5. The S&P 500 includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market. TR stands for total return and means dividends are included.
6. The Bloomberg Barclays Capital US Government Index includes Treasuries with maturities of more than one year and U.S. agency debentures. It is not possible to invest directly in an index.
7. Average shown represents arithmetic mean.

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Founded in 1979, BTS Asset Management is one of the oldest risk managers, managing traditional assets with a nontraditional approach. BTS has a multi-year track record in tactical fixed income and equity management. Our goal is to find opportunities with the potential to take advantage of rising markets while working to manage losses during downturns.

BTS:

- Seeks to preserve capital
- Aims to offer downside protection and upside potential
- Strives to reduce volatility while delivering consistent long-term returns

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