Fixed Income Advice for Advisors

By Editor Test *Tue, Jun 1, 2010*

Kathleen C. Gaffney, CFA, is a fixed income portfolio manager at Loomis, Sayles & Co., a Boston-based unit of Natixis Global Asset Management. In a recent webcast, she briefed advisors on a report, Multisector Strategies in a Rising Rate Environment, by herself and Dan Fuss, Matt Eagan and Elaine Stokes of the Loomis, Sayles Multisector... Read more »

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In the following excerpts from their report, they describe four rules for making money in bonds today: Maintain a yield advantage; Maximize specific risk; Minimize market risk; Go global:

"Yield advantage is a powerful offset to the headwinds of rising interest rates. We strive to build portfolios with a significant yield advantage over what might be earned by a portfolio that is similar to, say, the *Barclay's Capital Government/Credit Index*." If rates go up 75 basis points and prices go down, for instance, you'll still be making money on a BB bond paying 7%. But you'll take a loss on a Treasury note, they write.

"An experienced bond picker can often counter the headwinds of a rising interest rate environment… We are currently on the hunt for securities with positive corporate fundamentals, including: Companies with strong market demand and a global reach, including emerging markets; fast-growing companies that can deleverage and be eligible for upgrade; opportunities across the entire capital structure; new, innovative industries."

Don't necessarily go to short maturities in this environment, Loomis, Sayles says. "Many financial textbooks teach that reducing duration is among the best prescriptions for protecting a bond portfolio from rising interest rates. However, this advice leaves out a couple of important points. First, timing is important. The slope of the yield curve is exceptionally steep at the moment (the 10-year US Treasury yields approximately 280 basis points more than the two-year US Treasury)."

"Dramatically shortening a bond portfolio's maturity therefore would carry a penalty in the form of a large yield give-up. Our interest rate outlook suggests it may be simply too early and too costly to significantly shorten duration at this point. While we have trimmed some longer bonds at the edges in recent months, we don't believe another significant move is likely to take place until later in this cycle."

"On a relative basis, TIPS may outperform nominal Treasury bonds significantly. However, unless inflation ramps up very quickly in the next couple of years, we do not believe TIPS offer enough absolute return potential to warrant an investment. Given their low coupon, low yield, and the absence of a clear near-term inflation trigger in the markets, we would likely not utilize TIPS in our portfolios at this time."

Loomis, Sayles also recommends investing in non-U.S. dollar denominated bonds. “We are not necessarily universally negative on the US dollar. In fact, we think the greenback should fare well versus the other major reserve currencies, the yen and the euro, which are tied to countries with slower growth rates and weaker demographic trends. But we do see the U.S. dollar adjusting lower to currencies tied to the faster growing regions of the world in Asia and Latin America.”

“We favor the Australian dollar, the New Zealand dollar and the Canadian dollar, which are collectively referred to as ‘commodity currencies.’ These small, resource-rich countries can directly benefit from any growing demand for raw materials coming from emerging markets. We believe building positions in sovereign and corporate debt denominated in these currencies can assist the portfolios by acting as a natural hedge against inflation expectations in the U.S.”

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