OUR FIXED INCOME PHILOSOPHY

The fixed income market is incredibly diverse. Some securities like municipal bonds are exempt from federal taxation. Most other bonds, however, pay interest that is federally taxable. U.S. Treasury bonds have virtually no default risk. Yet every year a large number of high-yield corporate bonds default, meaning they fail to pay back all principal and interest.

This diversity means one approach to fixed income can behave completely differently from another. For example, in 2008 if you allocated your entire fixed income portfolio to high-yield corporate bonds, you would have experienced returns of roughly –25 percent. Treasury bonds, meanwhile, were up about 15 percent.

Buckingham's approach focuses on the overall role fixed income plays within a diversified portfolio. We consider the tax implications, how fixed income complements the stock portion of a client's portfolio, and the appropriate amount of interest rate risk given a client's goals and risk profile.

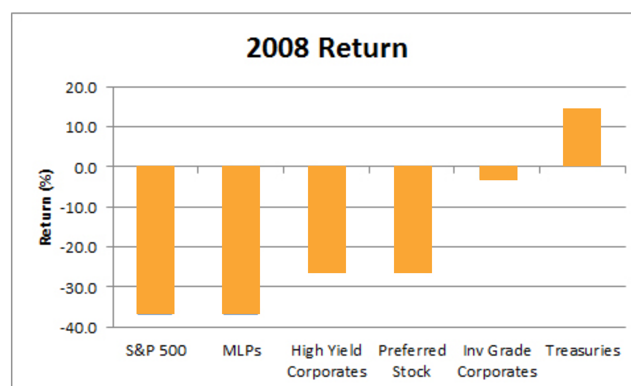
WHAT ARE THE TAX IMPLICATIONS?

For tax-exempt clients like endowments and foundations, tax implications do not affect our fixed income approach. But taxes are an important consideration for investors who have both tax-advantaged accounts, like 401(k) plans and IRAs, as well as taxable accounts.

The two basic tax-management principles we emphasize are 1) sheltering fixed income from taxation by generally placing it in tax-advantaged accounts like IRAs and 401(k) plans, and 2) factoring in specific federal and state tax circumstances when purchasing fixed income in taxable accounts. Over time, both strategies can add meaningful after-tax return to your fixed income portfolio.

HOW DO BONDS COMPLEMENT STOCKS?

We believe the primary role of fixed income is to reduce the risk associated with the stock side of the portfolio. The only way to accomplish this objective is by owning high-quality bonds like U.S. government agency bonds, CDs and highly rated municipal bonds. We generally avoid corporate bonds and "pseudo" fixed income strategies like preferred stock, high-dividend-paying stocks and master limited partnerships (MLPs). The first chart helps illustrate why.



Sources: Bloomberg and Barclays Capital Live

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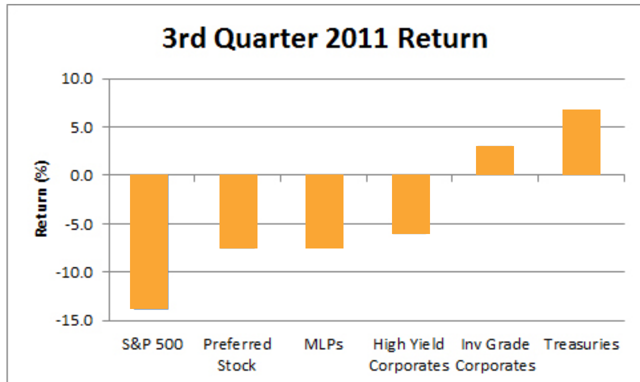

Sources: Bloomberg and Barclays Capital Live

These two points in time show that when stocks do poorly, high-quality bonds tend to do relatively well, while other strategies tend to perform poorly. For example, in the third quarter of 2011, when the stock market was down 14 percent, preferred stock was down 8 percent and MLPs were down 7 percent. Treasury bonds, meanwhile, were up 7 percent.

We also believe stocks are a more tax-efficient way to take risk compared with most other strategies. A tax-efficient stock portfolio generates most of its return in the form of unrealized long-term capital gain. A substantial portion of the return of most other investment strategies is subject to ordinary income tax rates. For example, instead of structuring a portfolio with 60 percent in stocks and 40 percent in high-yield corporate bonds, you could allocate about 85 percent to stocks and 15 percent to high-quality bonds. In doing so, you would have roughly the same risk-reward trade-off but improved tax efficiency.

WHAT'S AN APPROPRIATE AMOUNT OF INTEREST RATE RISK?

Most individual and many institutional investors are exposed to inflation risk. If inflation ends up higher than what the market expected, the living expenses for individuals will grow more quickly than expected. For institutions, expenses may also increase more quickly than expected in such an environment. Therefore, investment theory would say these investors should avoid investments that expose the portfolio to substantial inflation risk. Our general guidance is to avoid longer maturity bonds and bond funds since these investments tend to perform poorly in inflationary environments.

Beyond inflation considerations, the shape of the yield curve influences our guidance. When yield curves are steep, meaning short-term rates are substantially lower than intermediate-term rates, we tend to recommend portfolios with slightly longer average maturity. We tend to recommend shorter-maturity portfolios when the yield curve is flatter. These recommendations come from the general findings in peer-reviewed academic work that shows that extending maturity tends to lead to higher returns when yield curves are steep compared with when they are flat.

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