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What You Need To Know To Maximize Income Returns In Your Portfolio

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Most money managers tend to follow a traditional two-step process for constructing their model portfolios and arriving at the optimal risk versus reward tradeoff for clients. First, a ratio of stocks to bonds is proposed. For example, when an advisor tells a client "we'll give you a 60/40", it is shorthand for an allocation of 60% stocks and 40% bonds. From there, a client can typically slide down the stock-to-bond scale in 10% increments, meaning that a 40/60 or a 30/70 should be gradually more conservative, while a step up to 70/30 or 80/20 is intended to be an aggressive move.

Second, for each side of that ratio, individual securities must be chosen to represent the respective categories. Typically, since the stock side involves greater variance, a portfolio manager will spend their time and emphasis researching, screening, studying, and deciding on the most promising companies, or the mutual funds and ETFs that invest in those companies. Most practitioners would likely say that the over-performance of their model, or under-performance, is attributed primarily on getting the equity part of the equation right. Plus, for so many who love their job, equities are the "exciting" part of the business. Every good manager wants to find the next Amazon or Apple and deliver it to their clients.

Fixed income decisions, on the other hand, tend to either follow a boilerplate approach (for example, U.S. Treasuries with laddered maturities 10 years and lower), or are left to a passive index fund or a trusted brand name in fixed income investing. All of these approaches can potentially be smart and lead to favorable performance. However, given the current climate and complexity of the global fixed income market and the wide range of performance outcomes, it is crucial to research and understand the drivers of fixed income return and make decisions dynamically in response to a changing outlook for the bond market, economy, and level of interest rates. It is not enough to simply believe that fixed income will take care of itself or that the risks are minimal. Clients nearing retirement often ask for the more conservative mixes such as 30/70 and 40/60, and when a portfolio is 60% to 70% bonds, it is simple math: how the bonds are handled becomes the primary driver of return.

Investors quickly discover a couple of sobering realities in regard to their fixed income positions. First, the fixed income label is a misnomer: actual income yields are not fixed but will rise and fall primarily as a function of interest rate policy from the Federal Reserve and other central banks throughout the world. Second, there is downside risk, which can result from factors such as higher interest rates, higher default rates, or higher pre-payments of mortgages (if they are reinvested at less favorable rates). It's this second factor that tends to shock clients who are conditioned to think of fixed income as a safe haven from the volatile stock market, only to find that there are periods when those positions decline.

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A portfolio manager should take a few basic ideas into his choice of fixed income investments. First and foremost, what is the outlook for the direction of interest rates over the next 6 months to a year? What interest rates have done in the past 12 months is a helpful guide, but not necessarily predictive of anything. Only the future counts. If a manager believe rates are rising, then bonds with longer maturities are more vulnerable and short maturities should be over-weighted. Falling rates have the opposite effect. Getting the maturity right (or the "duration", which is essentially the weighted average time needed to receive cash from bonds) is the single most important element to the manager.

Other questions can be nearly as important. What percentage should be allocated to overseas bonds? In other areas of the world, the interest outlook could be more favorable, and there is often a yield pickup particularly with emerging markets bonds, but the uncertainties with local economies and those central banks must be understood. Similarly, how much should be allocated to high-grade corporate bonds and to lower-grade corporate or so-called "junk" credits? This decision usually goes hand-in-hand with one's short term economic forecast.

Retirees tend to use fixed income securities in increasingly higher percentages as they move from savers to users of their retirement accumulation. The important perspective to gain from these questions, is partly to know what a manager is doing now, but even more important, how ready they are to change and perform tactical reallocations to the portfolio. The world is not static; economic conditions change, interest rate policies change, and similarly a portfolio manager must always be ready for any and all possibilities.