By Erik Ford

Fixed Income, No Income

In the context of investing, "fixed income" refers to bond investing, or investing in other types of debt instruments. The description comes from the fact that with debt instrument investing, the principal is returned (hopefully) in a known amount at a predetermined date with a contractual income stream paid until maturity. The periodic income stream (interest payment) is fixed by contract, although it may actually be at a floating rate, thus "fixed income." This is opposed to equities, or stocks, where both the future value and any intervening income is not known or assured.

The traditional role fixed income has played in portfolio construction has been to provide stability of principal with modest income. Around this presumably stable core asset, more risky assets are added to varying degrees to match the risk profile and investment horizon of the investor. The current interest rate environment has given us reason to rethink that simple approach.

First, let us take a step back to describe how fixed income instruments are valued in the financial markets. As an example, we will use a bond with a ten-year maturity and paying a 4.0% annual interest rate. If the prevailing (market required) interest rate for this obligation is also 4.0% and the bond will return its principal of $1,000 in ten years, then the market value of the bond should be $1,000. You expect your fair return of 4.0% a year and the payment of principal at maturity. Now if the prevailing rate for this bond drops to 3.0%, your contractual interest payment of 4.0% is higher than the market demands, so the market price of this bond should increase above the $1,000 principal amount, as you are being "overpaid" via the contractual interest rate and someone looking for the required 3.0% yield will bid up the price until it results in that lower total return. On the contrary, if the required interest rate for this ten-year bond increases to 5.0%, the contractual rate is not sufficient to generate the required return, so the price of the bond in the market should decline to the point that the total return equates to 5.0%. As an example, a 1.0% rise in interest rates will produce a 9.1% decline in the value of a ten-year treasury bond, a sizable change that may surprise some. When taken together, those examples explain the concept of bond prices moving inversely to interest rates.

In today's environment, we are faced with historically low interest rates with very little room to go down further. Although negative rates are possible and do occasionally exist, they are not a positive sign for the economy. The yield on the ten-year treasury bond has ranged from 0.52% to 1.88% since January of 2020 and currently is a little over 1.0%. While expectations are for rates to stay relatively low for some time, any movement up would be negative for bond/fixed income values as detailed above. So, we are in a situation where low to moderate risk fixed income investments produce very little income and introduce asymmetric (i.e., only downside) risk as to principal value. The traditional role of fixed income in a portfolio, modest income with lower risk, has been turned on its head to be no, or negligible, income with more risk to principal value.

The above is not to say that fixed-income investments do not have a role in an investment portfolio today, but the expectation for including fixed income in a portfolio needs to be realistic as to current market conditions. How this is addressed is obviously a very individualistic analysis and may include alternatives not considered before in order to make our risk/return expectations consistent with our planning goals.

As a final note on fixed income valuation, there are other factors besides maturity and interest rates that come into play but are beyond the scope of this article. Across the spectrum of fixed income, time and yield are the primary drivers of value and price change.

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