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YourQ&A: What's the Role of a Total Return Bond Fund?

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Question

Given today's environment, what is the role of a total return fixed-income manager? Do clients just want yield?

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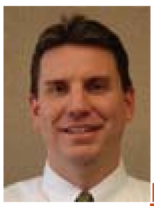
Answer



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A total return fixed-income manager's respective role, if selected by an advisor or investor within a given portfolio, should be to provide for total return potential within its own risk parameters and investment philosophy. This should be the case regardless of the current state of the market. These managers can generally be accessed through open-end mutual fund, closed-end mutual fund and separate account manager strategies. Each of these strategies has its own set of pros and cons. As a point of reference, total return is a function of price appreciation and dividend income. In general, when bond prices are falling, interest rates/yields rise, and when interest rates/yields are falling, bond prices rise.

On the other hand, investors may not be looking at fixed-income investments solely for the asset class's total return potential. Instead, they may be seeking a predictable stream of income and principal protection (when held to maturity). We have seen investors purchase single-issue bonds through a qualified advisor, as opposed to employing a fixed-income manager through one of the strategies discussed above.

The second part of this question is a difficult one to answer as every client is different. Some clients use fixed-income as part of a broader asset allocation strategy, while other investors use the asset class for the retirement income, principal-protection purposes mentioned earlier. In either case, I do not believe that these investors are, or generally should be, focused purely on yield. Remember that yields are often a by-product of other factors that should be taken into strong consideration by investors, such as maturity, credit rating, insurance backing and security type. Typically, higher yields are associated with riskier investments. These risks should be completely understood by investors before making an investment.

Answer

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It is always the right time for a total return approach* to fixed-income management. Investing solely on the basis of the yields currently available may lead to unfavorable performance. Investors in diversified bond portfolios, looking at yields that seemed attractive based on historical norms undoubtedly didn't expect to underperform Treasurys by roughly 2.5% in October. This was the case when yield spreads widened between corporate, U.S. Government Agency, mortgage-related debt and U.S. Treasury securities. An argument often given by investors who use current yield as the basis for their bond investment decision is that if the bonds are held to maturity they will return to par value. That is true. However, that logic also assumes investors aren't required to sell bonds to maintain their lifestyle. The risk of such an outcome may be high if bonds make up a significant portion of the portfolio allocation — typical for conservative investors. Furthermore, avoiding even "paper losses" by temporarily holding other investments such as cash can make a meaningful contribution to long-term investment success. While a total return approach obviously is not always right, focusing on the right problem — return — hopefully increases the odds of getting the correct outcome.

After the October increase in spreads, however, current yields may seem attractive. The yield on the short-term debt of at least one former blue-chip financial company has breached the 20% mark. But the outlook for "spread product" remains highly uncertain. The various bailout programs have not yet established stability in the financial sector. We still have not had price discovery for various categories of mortgage-related debt, and many other economic uncertainties loom. Meanwhile, the length of time the aggressive policy stance of the Federal Reserve will take to right the economy, given this backdrop, is not clear.

Remember that reaching one's investment goal depends on total investment returns. So when selecting a management strategy for any asset category including bonds, an investor should look to the prospect of total return, the process for achieving return and the strategy's risk. Our work suggests that an all Treasury bond portfolio provides a good basis for a total return bond investment strategy.

First, over time the return to an all-Treasury benchmark is competitive with market benchmarks that include mortgage or asset-backed, U.S. government agency and corporate securities. Secondly, an all-Treasury portfolio facilitates the implementation of an interest rate call by the manager. Finally, if spreads have widened to the point where non-Treasury securities seem like a good investment, relatively expensive Treasurys may be sold to finance the purchase of other now cheaper bonds (this is assuming that yields will have the ability to move higher still). Yields may signal a short-term opportunity even though they may not be the basis for a long-term investment approach. When spreads narrow, profits can be realized and the proceeds returned to Treasury securities.

**One that considers both the yields currently available and the likelihood that bond prices will change.*

Answer

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In today's environment, the role of a total return fixed-income manager is to control risk. Clients look to the fixed-income portion of their portfolios for diversification and to reduce overall volatility. Historically, bonds tend to do well when stocks are falling. However, this is not the case in the current environment, as all but a few sectors of the bond market are down substantially. This makes the total return fixed-income manager's job of controlling risk that much more important, as substantial short-term underperformance can erode long-term growth. The qualitative aspect of the research process has become much more imperative now too. It's crucial for these managers to truly understand what they are investing in and what the potential risks are within each sector and security. This can help them avoid the blow-ups that have caused so much havoc recently. Clients look for more than just yield from their total return funds. Over time, they expect income generation and capital appreciation. They expect their bond portfolio to smooth out returns over the long run and preserve wealth.

Total return managers tend to be diversified across various sectors of the bond market, and are thus well suited to be a core holding in a client's fixed-income portfolio. A good total return manager is able to identify inefficiencies in good markets and take advantage of undervalued bonds, taking into account credit quality and duration. In bad markets, they are able to limit downside potential through broad diversification across sectors and term structuring.

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