LOOK FOR HIGH YIELDS, AVOID SHORT TERM BONDS

3 Minute Read

Look for High Yields, Avoid Short Term bonds

Short-term bond funds generally invest in debt securities with a duration of five years or less. They are often described in marketing material as a secondary liquidity source and having the ability to achieve a high level of current income, consistent with relatively low volatility of principal. After short-term interest rates fell to nearly zero in early 2020, many financial institutions invested in short-term bond funds to boost the yield on the portion of their portfolio that they wanted to keep safe. When short-term rates rise sharply, many investors have been surprised that the value of these funds quickly dropped.

What is a short-term bond fund?
Short-term bond funds seek a high level of income while attempting to maintain minimum fluctuation of principal. The funds generally invest in high-quality, short-term debt securities. Bond funds in this category tend to have lower interest rate risk than either intermediate- or long-term bonds, so they tend to hold up better when market conditions are unfavorable. Regardless of these objectives, it is possible to lose principal in a short-term bond fund, especially when short-term interest rates increase quickly. Recent price declines have provided a vital reminder that short-term bond funds should not be thought of as a cash or money market substitute.

Credit Quality
Not all short-term bond funds are created equal. Seeking higher returns, some short-term bond funds invest in low rated, high-yield bonds. These funds may be more volatile because the underlying securities are subject to both interest rate risk and credit risk. It is important to understand which funds are designed to meet your investment objectives. Short-term doesn't necessarily mean low risk. In addition to investing in only short-term bonds, the fund managers may have filled the portfolio with complicated international investments or low-quality holdings. These are the types of securities that are much more volatile in times of economic stress.

Short-term bond fund performance
Short-term bond fund performance is comprised of dividend income and total return. Dividend income is simply interest payments received over time, expressed as a percentage. The total return on a short-term bond fund includes interest payments and change in value. Higher interest rates will result in lower bond fund values. When short term rates rise rapidly, the value of these funds can fall quickly. A very large market rate increase can result in either significantly lower short-term bond fund values or negative overall total returns. As one recent example, most short-term bond funds are down in value by at least 3.5% in 2022 and some by as much as 5.0%. Even the best-performing short-term bond fund posted negative returns and was down 1.44%.

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What happens when rates fall?
When interest rates begin to fall, the market value of existing bonds held in a bond fund typically rises because their fixed coupon rates become more attractive compared to the lower rates offered on newly issued bonds. Some bond fund investors will decide to sell their shares to lock in the gains. Depending on the volume and timing, this selling action can have a significant impact on the fund:

- **Impact on Net Asset Value:** The value of a bond fund could potentially decline if a significant number of investors decide to sell their shares. This is because the fund may need to sell some holdings to meet redemption requests, which could lead to losses. It is also possible that this activity will result in a capital gain distribution to remaining shareholders and potentially result in a lower net asset value.

- **Impact on Portfolio:** The fund manager might have to adjust the portfolio to meet high redemption demand. If the fund manager sells a large portion of the bonds, it could potentially lead to less diversity in the portfolio, which could increase risk for the remaining investors.

- **Impact on Liquidity:** If a substantial number of investors request redemptions at the same time, it could strain the fund's liquidity. This might force the manager to sell bonds that they'd prefer to hold, which could potentially impact the overall strategy and returns of the fund.

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Bonds vs Bond Funds

To participate in the fixed-income market, you could buy individual bonds or purchase a mutual fund that invests in bonds. Investing in individual bonds and holding them until the maturity or call date enables financial institutions to manage interest rate risk and liquidity needs. In contrast, a bond fund pools together money from multiple investors. Thereafter, an investment manager purchases securities in accordance with the fund's stated investment goals. Bond funds don't have a stated maturity date. Compared to individual bonds, they don't allow investors the same opportunity to manage interest rate risk or liquidity needs. When shares are redeemed, the sale may result in a capital gain or loss. While the value of individual bonds also fluctuates during the holding period, a well-structured ladder of individual bonds will include defined maturity dates to meet liquidity needs. As such, the need to sell bonds before maturity and book losses is greatly reduced.

Accounting Treatment: Bonds

Accounting standards require institutions to classify bond purchases as held-to-maturity, trading or available-for-sale. The treatment of bond funds and individual bonds is very different.

- Held-to-maturity (HTM) securities are purchased with the intention of holding them until maturity. Some bonds and other fixed income securities, such as CDs are the most common form of HTM investments. Interest income appears on the income statement, but price fluctuations during the holding period do not change the income statement or balance sheet.
- Trading securities are purchased with the intent of selling them within a short period of time, usually less than a year. Held-for-trading securities are reported at fair value. Therefore, gains or losses are reflected in earnings.
- Available-for-sale (AFS) securities are reported at fair value. As such, changes in value between accounting periods are included in accumulated other comprehensive income in the equity section of the balance sheet. However, there is no impact on the income statement.

During the holding period, individual bond values will fluctuate. Depending on accounting treatment, the change in value may simply be an unrecognized gain or loss. When bonds are held to maturity, investors are not affected by the change in value during the holding period.

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Accounting Treatment: Bond Funds
Since bond funds do not have a maturity date, they cannot qualify as held-to-maturity or available for sale securities. This means that the change in value of a bond fund flows through the income statement every month. While short-term bond funds may have benefits, investors need to understand that they are still subject to large price swings. If investors have learned anything by wide market rate increases, it is that short-term bond funds can lose a lot of money. While these funds may continue to provide income, investors may find themselves worse off when rates rise because the decline in value can quickly exceed the income payments. Holding bond funds requires immediate reporting of price changes, so the goal of capital preservation can be quickly defeated.

Action Items

- **Know what you own:** Many fund managers and brokers publicize the benefits of investing in short-term bond funds. Further, they often recommend them as a substitute for investors seeking to limit interest rate risk. Many investors were surprised when short-term bond fund values fell sharply over a short period of time. We recommend thorough review of potential price changes and accounting treatment of every fixed income security.
- **Build a structured ladder of individual bonds:** A mutual fund manager will never understand your asset-liability mix and liquidity needs. Short-term bond funds can't replace the stability inherent in a well-structured portfolio of individual bonds. We recommend building a well-structured ladder of individual bonds to closely match your liquidity needs and asset-liability mix.
- **Diversify by credit quality:** Depending on your risk profile, choosing lower quality bonds (but still investment grade) may provide enhanced returns. Not all institutions have the expertise or resources to review credit risk.
- **Diversify by market sector:** There are a variety of fixed income sectors, including mortgage-backed securities, municipal bonds, corporate bonds, US Agencies and certificates of deposit. We recommend diversification by sector to take advantage of the opportunity for higher returns.

McQueen
Financial Advisors

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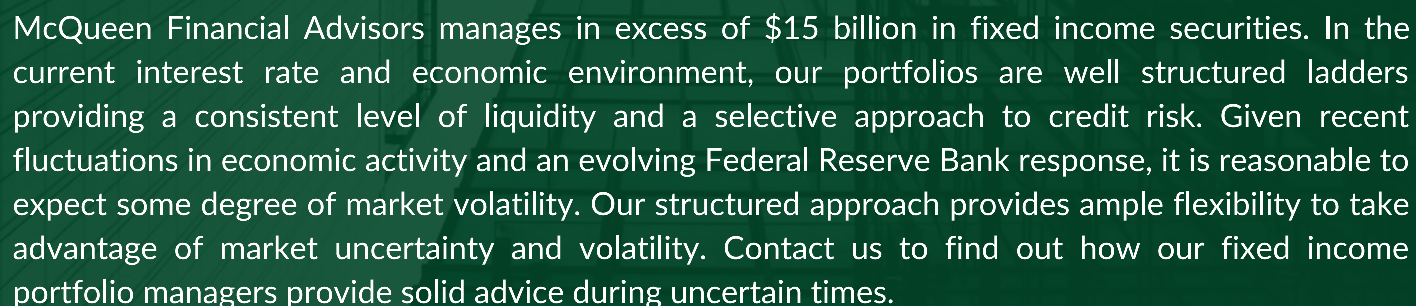

McQueen Financial Advisors manages in excess of $15 billion in fixed income securities. In the current interest rate and economic environment, our portfolios are well structured ladders providing a consistent level of liquidity and a selective approach to credit risk. Given recent fluctuations in economic activity and an evolving Federal Reserve Bank response, it is reasonable to expect some degree of market volatility. Our structured approach provides ample flexibility to take advantage of market uncertainty and volatility. Contact us to find out how our fixed income portfolio managers provide solid advice during uncertain times.