Would renaming the Fixed Income portion of an investment portfolio help us manage it better?

Fixed Income is defined in the Cambridge Dictionary as
:*used to describe investments such as bonds that pay the same amount of money every month, year, etc.*

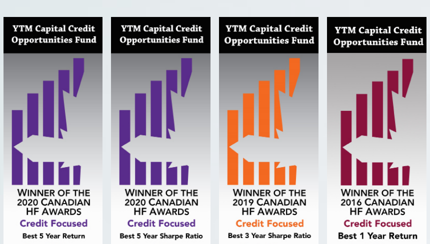
"Fixed Income" is a description of a specific type of security, yet we commonly use the term fixed income to refer to a portion of an investment portfolio. The inference is that this portion, which often represents 30-40% of a total portfolio, is made up of fixed income securities. We should ask: is the large allocation justified by fixed income securities or due to their expected attributes? Said differently, and in a 2021 context, are fixed income securities going to meet traditional expectations?

The attributes of fixed income securities include: a steady income and a low risk of loss, as well as total portfolio benefits due to their behavior profile as compared to other assets. The valuation of fixed income securities has an inherent - and inverse - exposure to changes in interest rates, and some have varying degrees of credit, liquidity and default risk. Importantly, most fixed income securities are high, if not senior, in the capital structure of the bond issuer.

Fixed income securities have largely delivered on these attributes for many years. Therefore, similar to the attachment of Kleenex, BAND-AID or Google brands to all products or services in a category, fixed income securities have become synonymous with a segment of an investment portfolio. We have come to refer to fixed income as that 30-40% complement, while instead we should be focused upon the risk and return factors that optimize that portion of the portfolio. If those factors are best satisfied in other ways, then maybe it's time to change the "fixed income" allocation reference to something like "Capital Preservation & Income Bucket" or "Lower Risk and Stable Return Portion", although neither are especially catchy.

Alternative thinking

The point is that there are a variety of ways to effectively construct what we have come to know as the fixed income allocation, and that several alternatives currently offer notable improvements over traditional fixed income securities. That fact is driven by the mechanics of and the current low level of interest rates. The nature of fixed income securities has not changed, but their ability to perform has. Low rates don't offer enough return, they don't have sufficient room to move lower to create capital gains and now face the risk of rising, which will lead to losses in fixed income securities. Therefore, fixed income alternatives are not "alternative" anymore; they are now essential!



The range of alternatives that may individually or in some combination meet the requirements needed for what we call the fixed income allocation are: dividend-paying equities, hedged credit funds, infrastructure equity, market neutral equity hedge funds, private debt, private lending, real estate equity, private lending and mortgages. Most or all of these replacements have attributes that make them candidates for consideration as an alternative to traditional fixed income, even though none are identical replacements. The good news is that each solution does not need to be identical, but their role in the total portfolio does need to provide the required factors, namely: portfolio risk mitigation, capital preservation, volatility buffering, diversification, liquidity, and the benefits of non-correlation to other asset classes.

But which alternative?

This list of so-called "alt's" is not homogenous, but each can be part of the solution. Importantly, total portfolio risk should not rise as we substitute for traditional fixed income securities, which may also require shifts in the "Growth or Equity" portion of the portfolio. The right complement for the "Lower Risk and Stable Return Portion" or fixed income bucket will allow the investor to optimize expected portfolio return, while maintaining risk within chosen parameters. Bluntly, low rates and potentially rising rates no longer allow traditional fixed income to deliver as effectively.

Bluntly, low rates and potentially rising rates no longer allow traditional fixed income to deliver as effectively.

It is important to note that total exposure to equity could sneak higher in the portfolio as these substitutions are made. It is critical to avoid that, especially with "lower-risk" equity alternatives that may seem safer than their potential outcomes and position in the capital structure.

From these alternatives it is the hedged credit strategy with a target of 7%-9% return after fees delivered over an investment cycle with a standard deviation of ~5% that stands out as a priority candidate. It, like the others, is not a perfect substitute, but we're not looking for a perfect package. We are looking to fulfill the essential portfolio factors and this strategy satisfies many of those essential fixed income-like attributes. Further, a 6%+ expected return, especially when delivered with lower risk and constructed with top-of-the-capital-structure fixed income securities, is attractive in almost any strategy these days. For an expert delivery of a credit hedge strategy, consider the award-winning YTM Capital Credit Opportunities Fund.

YTM | CAPITAL