Financial Planning

Not Dead Yet

Interest rates may be rising, but fixed-income products may bloom again in 2005.

By Justin Daniels

March 1, 2005- *"A Big Rise in Interest Rates Could Cost You a Bundle"*--N.Y. Post, *Jan. 25*

"Markets React Swiftly to Hawkish Fed Minutes."--Financial Times, *Jan. 5*

"Hawkish undertone to flurry *of talk from bank officials."*--MarketWatch, *Jan. 21*

With media coverage like this in January, it's no wonder a lot of financial advisers might have strongly considered taking their fixed-income investments out behind the proverbial woodshed and putting them out of their misery. The release of the minutes from the Federal Reserve Board's meeting in December produced big sell-offs in fixed-income investments and woke the world up to the possibility that the consensus view of a "measured" pace of rate hikes was not guaranteed.

Investors hate uncertainty, and the Fed minutes--as much as they tried to cement the notion that the U.S. global economic growth engine was in good shape--raised the specter that inflation may be more of a risk than previously thought. And with that, the speculation surged on how high interest rates might go to control rising prices and how fast they would get to their final destination. The end result? Various investment projections were rewritten, and the word on the lips of many was "sell."

Should this have come as a surprise to investors? The Fed has been signalling for some time that rates need to rise in order to move loose monetary policy up from an historic low of 1% to a more neutral range that will keep inflation in check and allow for healthy productivity. Analysts estimate rates will rise to the 3.75% to 4% range by the end of the year. But is that neutral?

Welcome to fixed income, circa 2005. Investing here need not be a struggle in a rising rate environment.

According to Strategic Insight, a New York-based mutual fund research firm, some $5 trillion in cash (held in retail money market funds and bank deposits) is waiting around for someplace to go. An aging population needing an infusion of fixed-income portfolio returns starting in the next five to 10 years means the sector won't melt down. In fact, through all the rhetoric and spin, 10-year U.S. benchmark bonds are hovering at 4.25%, about the same as a year ago.

On the other hand, bond funds will make up a smaller amount of new sales of all stock and bond funds in 2005--20% to 25%, Strategic Insight says. That is down modestly from 2004 and "way down" from around 50% in 1993.

"The issue is that there is so much demand for income vehicles," says Avi Nachmany, director of research at Strategic Insight. "Rising intereste rates are not a great time for bond funds, but not a disaster either."

Nachmany adds that in previous periods of rising rates, especially short-term rates, there was a dramatic slowdown in assets flowing into fixed income. "This time around, though, there is so much money on the sidelines that people are dying to get more yield. As a result, they are

more willing to listen to the bond story in a moderately rising interest rate environment," he says.

Financial planners are being forced to scrounge around for more focused fixed-income investments for their clients, whether they are in retirement or approaching it. That growing need has forced manufacturers to dream up new strategies and products--and to rethink existing ones--to address the new rising rate environment.

One emerging strategy is mutual funds that offer a diversified portfolio of income-producing instruments that may not even include bonds. "Buying long-term bonds exposes you to interest-rate risk," explains William Adams, executive vice president and head of the U.S. funds products group at Nuveen Investments in Chicago. "Investors today are demanding income, but they're also asking for more diversified and more risk-controlled fixed-income investments.

He cites Nuveen's diversified dividend and income fund as one example. The fund's assets are invested in dividend-paying equities, real estate investment trusts, emerging-market sovereign debt, and floating-rate corporate loans. This eclectic mix of investments produces a steady stream of income from a diversified range of assets that are "uncorrelated or less correlated to each other," Adams says.

The Nuveen executive also mentions utilizing exchange-traded funds (ETFs) for the fixed-income market. Traditionally, ETFs have largely been the domain of equity investors, but there has been some growth recently on the fixed-income side.

Nachmany, on the other hand, is not as optimistic about fixed-income ETFs. "Most EFTs mirror an equity market segment. It's much harder to construct a bond ETF. So far, there has been little new product creation in this area," he notes. "In fact, bond ETFs account for only about 3% of the U.S. ETF market today-about $8 billion."

Still, Adams claims that closed-end ETFs that invest in floating-rate loans are proving attractive, especially in a rising rate environment. And other ETFs are being used to buy short-term corporate loan investments. "Last year and in early 2005, we saw a variety of funds that tried to stay on the very short end of the yield curve and minimize duration," Adams says.

Nuveen is also developing equity ETFs that maximize yield. In late January, the firm raised $1.3 billion in an initial public offering for its Equity Premium Opportunity Fund, which invests in diversified common stock and replicates the average price movements of a blended index of the S&P 500 and the Nasdaq 100.

The equity portfolio is expected to generate a dividend yield that is higher than the weighted average yield of those two indexes. The fund will sell index call options on a continuous basis while also buying index puts to provide some downside protection.

Yet another emerging fixed-income strategy is investing in inverse bond funds, says Robert Quan, a research analyst at Boston-based Financial Research Corp. These funds take short positions in bonds with the expectation that rising rates will drive bond prices down. "But since no one knows how long the Fed's latest tightening cycle will last, there are obviously market timing risks to consider," Quan adds.

Only ProFund Advisors and Rydex currently offer these kinds of funds, according to Quan, and their sales have risen along with broader market expectations for higher interest rates. In the first three quarters of 2004, according to FRC, net inflows into the Rising Rates Opportunity ProFund and Rydex Juno fund reached $400 million and $2 billion, respectively.

On Jan. 24, ProFund launched a similar fund, the Rising Rates Opportunity 10 ProFund, which is based on movements in the 10-year Treasury note's price movements. Rydex also manages a closed-end bond fund betting on rate rises for Merrill Lynch.

Quan says that interest is growing in step-up notes as well. Step-up notes are bond funds with a call feature and a coupon that increases annually over the life of the bond.

"If the bond isn't called, it steps up' to a higher coupon, thus lessening interest rate risks to the investor. If rates fall, the issuer is likely to call the notes and then refinance at a lower rate," Quan explains. Because step-up notes do not yet have a strong secondary market, that may hamper fund development, at least for the time being, he adds.

"You are essentially playing the call market, if you will," says Joe Birkofer, a CFP and principal of Legacy Asset Management in Houston. "In a rising interest rate environment they are getting called all the time, and that means you get the money back and can reinvest at higher yields." Considering the thin secondary market and the higher transaction costs, advisers need to watch step-up bonds closely.

Quan also highlights growth in inflation-protected corporate notes. These notes are basically Treasury inflation-protected securities (TIPS) with a corporate backing.

Unlike with TIPS, where the principal amount adjusts to inflation, the corporate notes offer an adjustment in the interest payments. Every three months, the coupon is adjusted based on the 12-month change in the U.S. Consumer Price Index.

Fixed-income opportunities are not only domestic, of course. In fact, international opportunities are growing more abundant. "The fixed-income market overseas has matured significantly over the last 20 years," Birkofer says.

This is important, he adds, because while interest rates have been generally rising in the United States, the overall rate environment seems to be lagging behind in Europe, "probably by from about 18 months to two years, depending on the country," he notes. "So there are now more opportunities for investors to be in a long position in fixed income in Europe, whereas you have to stay short domestically."

The U.S. dollar is likely to erode further in 2005 given the staggering twin deficits--current account and fiscal--that have grown expotentially in the last four years. So any expansion into European fixed-income assets will likely continue to benefit from an extra boost from euro appreciation.

For 2005, money is likely to find a home in inflation-linked bonds, both in the United States and in the euro zone. According to JPMorgan, as much as 65 billion euros worth of inflation-linked debt is likely to be issued in the euro zone area in 2005, up from roughly 43 billion in 2004.

Germany has said it plans to issue about 5% of its total government bond issuance as inflation-linked debt. The consensus view among analysts is that Germany will likely issue these bonds in the 10-year maturity range, where the demand is said to be strong. Germany's introduction of inflation-linked debt in 2005 marks the final G7 country to offer such bonds.

Another area to watch is the credit derivatives market, with Europe also set to post solid growth. In fact, the European Central Bank gave the sector an endorsement late last year when it said, "Credit derivatives are well on the way to becoming on of the most successful financial innovations in recent history." In addition, the British Bankers Association has forecasted the global market for credit derivatives is likely to mushroom to $8.2 trillion in 2006 from $5 trillion at the end of last year.

Credit derivatives allow banks and financial institutions to transfer to investors the risk of a company defaulting on its debt. Investors can bet on this market and earn a premium by taking on the risk. The merger of iBoxx and Trac-X, two rival default-swap indexes that together now form the DJ iTraxx family, will likely help fuel much of the rise in this market sector, since portfolio managers can now trade this credit as a separate asset class.

Although interest rates have been creeping up , not all advisers are ready to concede that we are really in a rising rate environment. "I'm not so convinced," says Paul Winter, principal of Five Seasons Financial Planning in Holladay, Utah. "It's a rather sweeping comment to make. Yes, the Fed has raised rates, and short[-term] rates have followed, but at the same time the 10-year [Treasury] has remained relatively unchanged over the past two years."

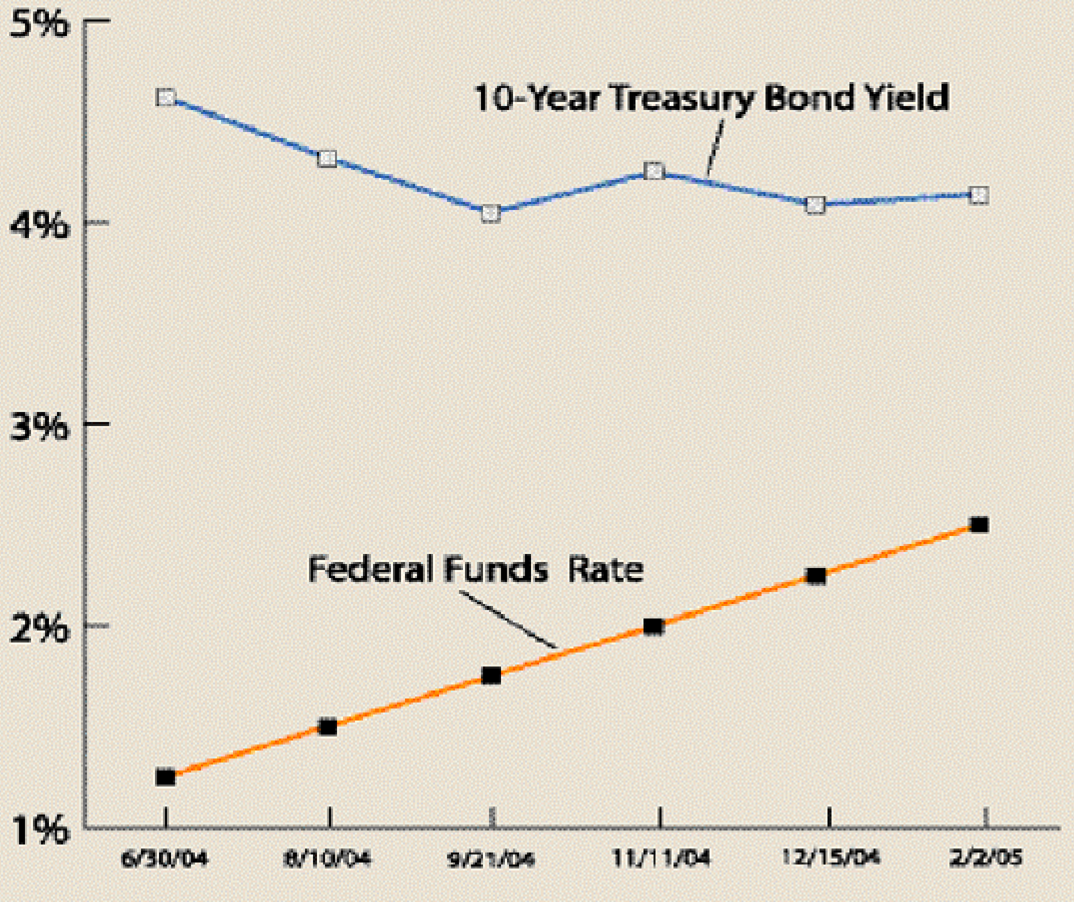
Winter, who traded mortgage-backed bonds for CSFB, UBS, and Yamaichi before founding his own financial planning business, highlights the flattening yield curve and tighter credit spreads around the world. In this environment, Winter is looking to play it safe with floating-rate instruments, such as short-term bank loan funds and TIPS.

In fact, 2005 may very well turn out to be "the year of the bond," according to Lombard Street Research (LSR), an economic consulting firm in London. In a Jan. 4 research note, the firm predicted that U.S. growth, with fiscal and monetary policy mildly tightening, should be slower in 2005 than the previous year. Meanwhile LSR expects China to slow, down, and that country is liable to have a hard landing.

"A lower overall return on capital, with the shorter end of the interest rate spectrum being hoisted by Fed policy, suggests distinctly lower bond yields," LSR wrote in its January note. "A moderately strong bond market could boom if U.S. households lose their confidence in rapidly rising housing prices. While this is likely to occur in the next year or two, it may not happen in 2005. So the safest bet for this year looks to be Japanese government bonds."

LSR says that deflation in Japan is likely to intensify again. Although 10-year Japanese government bonds only yield 1.4%, that number could fall well below 1% in a year or two.

In the end, 2005 may not be the big disaster for fixed-income products that everyone has been predicting. If short-term interest rates continue to rise in a measured way, financial advisers need not panic-just continue to search for the right strategies to meet their clients' income needs.



Justin Daniels is a freelance business writer. In the November 2002 issue, he looked at the challenges faced by investment advisers in the wake of the Sept. 11, 2001, attacks.

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