Fixed income: What is it, and what do I need to know to safeguard my security?

NEWS

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Q: My portfolio analysis states that I am 40% in “fixed income." What does this mean?

A: Fixed income require that you lend money to another entity in return for both getting your money back along with some interest payments. A bank CD is a classic example. Imagine you give the bank $1,000 for two years. During that time, you receive interest periodically and then get back your original deposit at the end of two years. All of this is the same if you purchase a U.S. Treasury Bond for two years.

The entity you lend to and how the loan is secured depends greatly. You might loan on home mortgages and have a claim on the underlying properties if the loan is not paid back. You might be loaning to a city, county or even another country and have very limited ability to claim any assets if the loan fails (defaults).

We consider several factors in evaluating the investment profile of fixed income. Important factors include credit risk, time risk, inflation risk and interest rate risk.

Credit risk refers to the chance you don't get back all or any of your money. This might be a "junk bond" issued by a company that has a shaky future. They might offer a high interest rate to induce investors to lend them money, but the loan is risky in terms of paying off as promised.

Conversely, U.S. government securities are felt to be risk-free in credit risk as the government can always print more money to pay you back (note that this money might not be worth as much as you'd like and therefore be subject to inflation risk).

Time risk represents how long you lend the money for (such as a five-year vs. a 10-year bond). A longer time exposes you to more risk -- the entity you lend to has more chance for something to go wrong (a change in credit risk). Also, the effects of inflation and interest rate changes might be larger than anticipated (discussed below). In a traditional economy, longer term loans carry higher interest rates for this reason.

Current and expected inflation is a factor in fixed income. If current inflation is around 3% a year and expected to be the same during the term of your loan to someone else, you'd want to earn enough to pay for the inflation plus taxes during the loan term at the very least (to preserve the value of your original dollars loaned). You must also compensate for the reduced value (due to inflation) of the money you get back at the end of the loan. If you loan some money for 10 years, the original sum repaid is worth much less in purchasing power.

Interest rate changes while you own fixed income can dramatically affect the value of your holdings. We saw this well in 2022-2023 when the Federal Reserve raised interest rates rapidly and strongly. All the older existing fixed income was paying much lower interest rates than the new fixed income, meaning that the existing fixed income had to be sold at much lower prices.

As an example, say you bought a 10-year, $1,000 CD that paid 2% a year three years ago. Current 10-year CDs pay 5% interest. If you wanted to sell your (now seven-year) 2% CD, you'd be offered a much lower price than your original thousand dollars, such that the buyer would be getting a roughly 5% return on their money for the rest of the term. The reverse happens when interest rates drop as occurred from the 1980s to 2007. Although interest rate changes can reflect the presence or belief in inflation, they can also change for other reasons.

All of these factors much be considered in making fixed income investments. Every investor has different needs and risk tolerance to consider. It's not easy.

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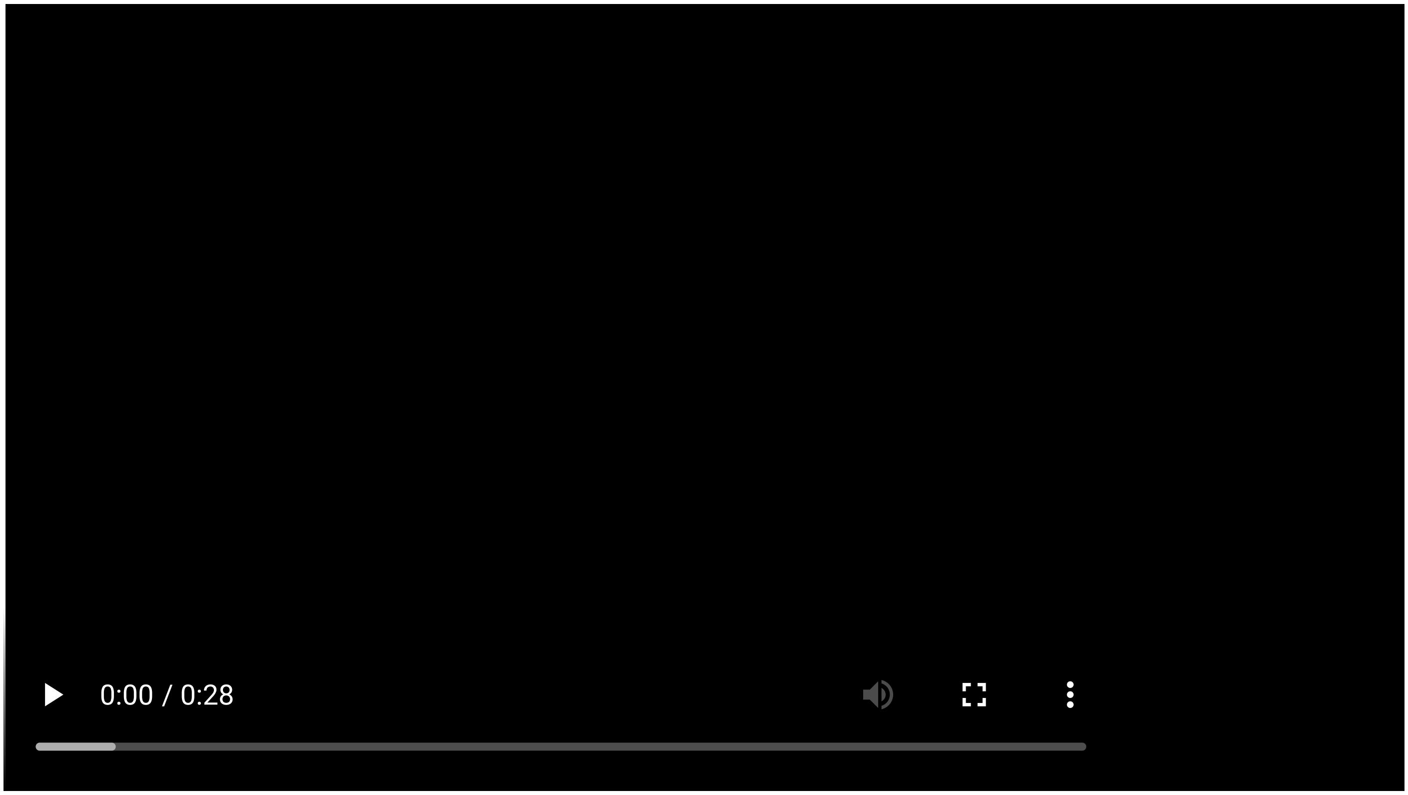
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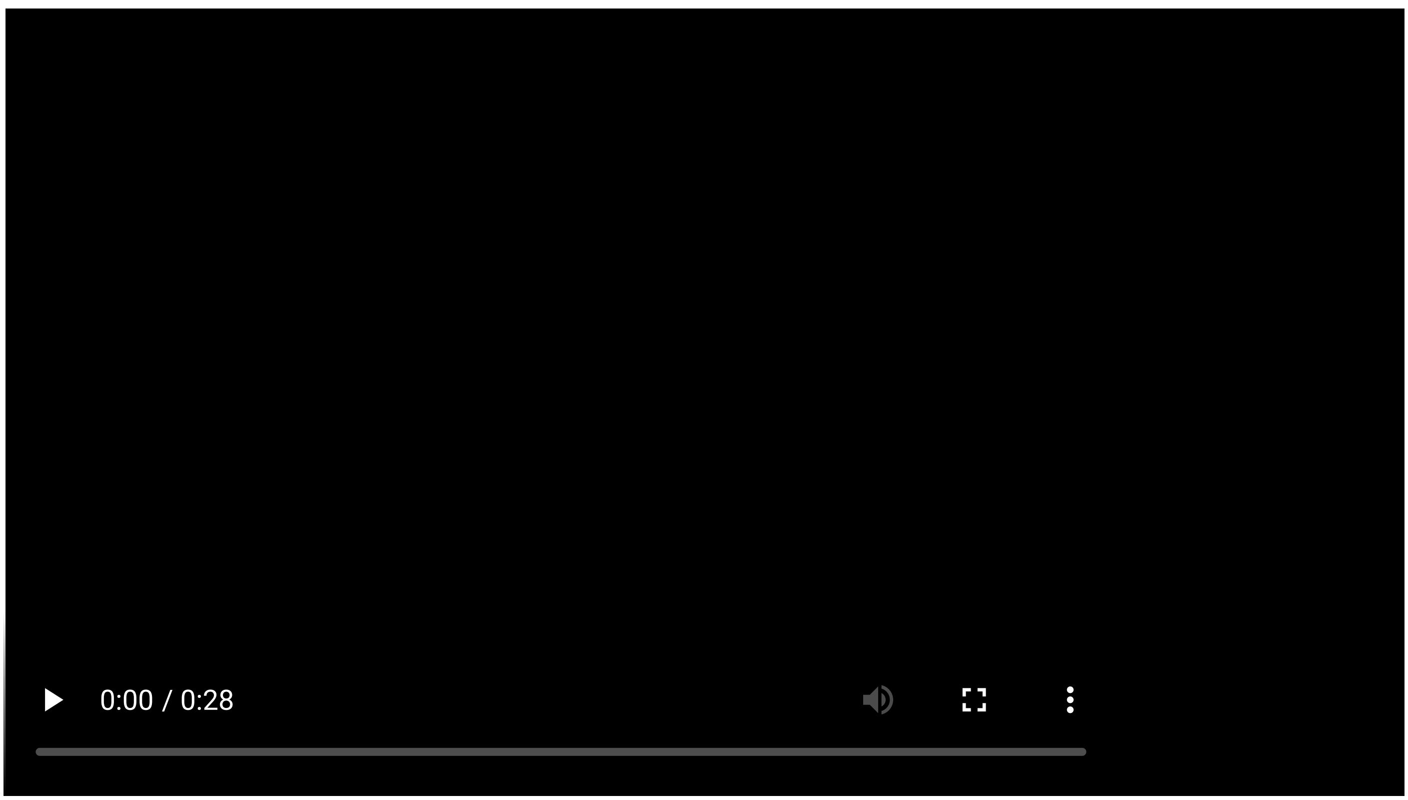
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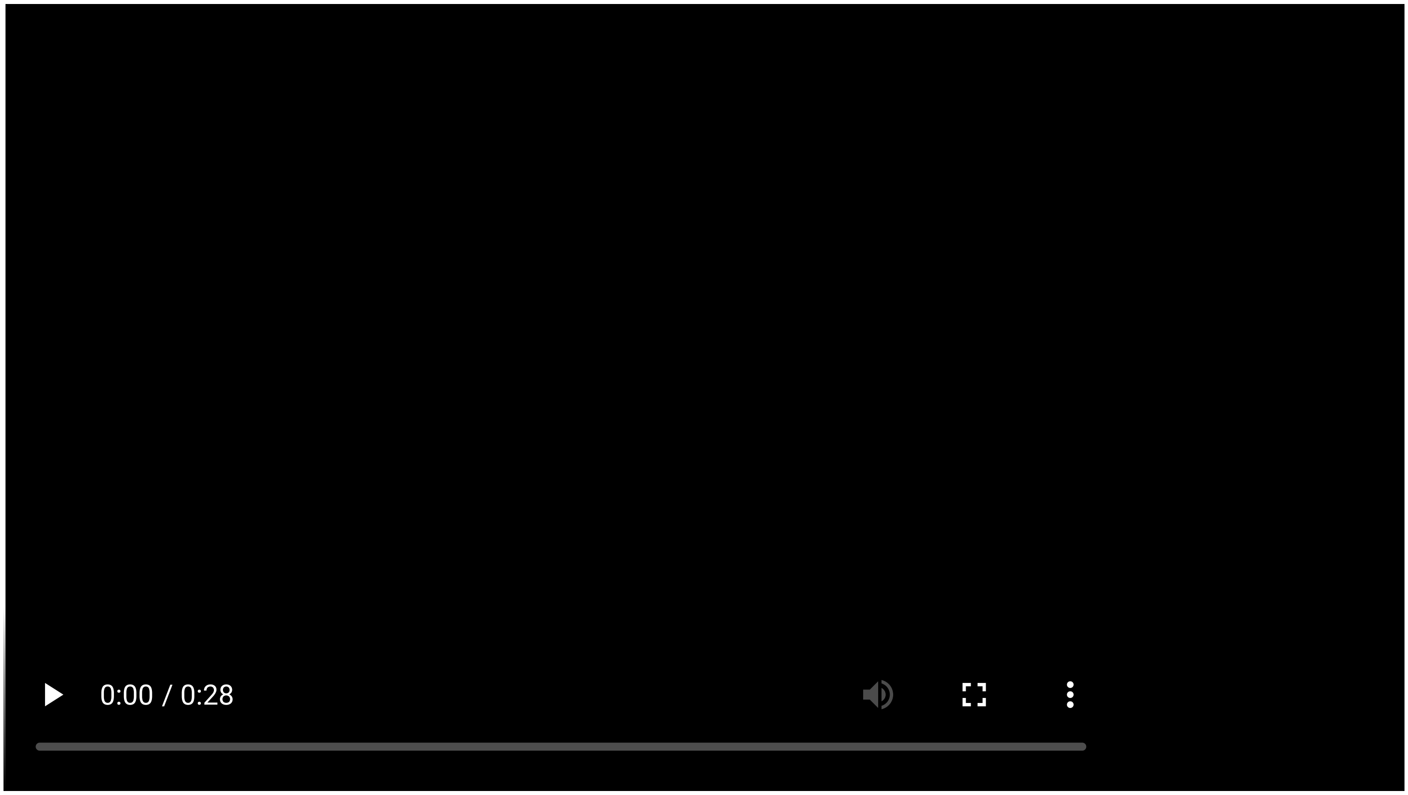

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