TD Wealth

Flexibility is Key in the Changing Fixed Income Landscape

Over the past 30 years, fixed income markets experienced a generational tailwind while interest rates declined to historical lows, which benefitted both active and passive fixed income investors. However, that tailwind has been dissipating, and may now have ended following the Federal Reserve's (the Fed) December announcement that it had raised the federal funds rate for the first time since 2006.

The Fed emphasized that it will take a gradual, data-dependent approach to further increases, and we believe rates will remain low for a prolonged period. Nonetheless, the Fed's move means that the tailwind fixed income investors had been enjoying has now finished. In addition, the market environment has become more complex, creating a more challenging environment for fixed income investors.

Despite these increasing challenges, opportunities to preserve capital and seek additional return remain. Specifically, the fixed income team ("we") at TD Asset Management ("TDAM") believes that moving from a passive solution to an active one affords investors greater flexibility and may assist them in meeting their objectives. We outline our rationale below.

An Evolving Index

The low yield environment has contributed to notable changes in the Barclays U.S. Aggregate Bond Index (the standard fixed income benchmark in the U.S.), with a significant increase in the Index's duration[1] and a marked decrease in the quality of the corporate bonds included in the Index. It is important for passive investors to be aware of these changes as their investments track the entire Index and are exposed to all its inherent risks.

Longer Duration

Over the past few years, low yields have provided an incentive for both government and corporate bond issuers to take advantage of low financing costs, which has resulted in issuers coming to market with longer dated bonds at lower coupons. This has contributed to the extension of the Index's duration over the past decade, making it more sensitive to changes in interest rates.

Securities and Investments		
Not FDIC Insured	No Bank Guarantee	May Lose Value

[1]Duration is the measure of a portfolio's overall sensitivity to a change in interest rates: the longer the duration of a portfolio, the greater the impact on the market value from a change in interest rates.

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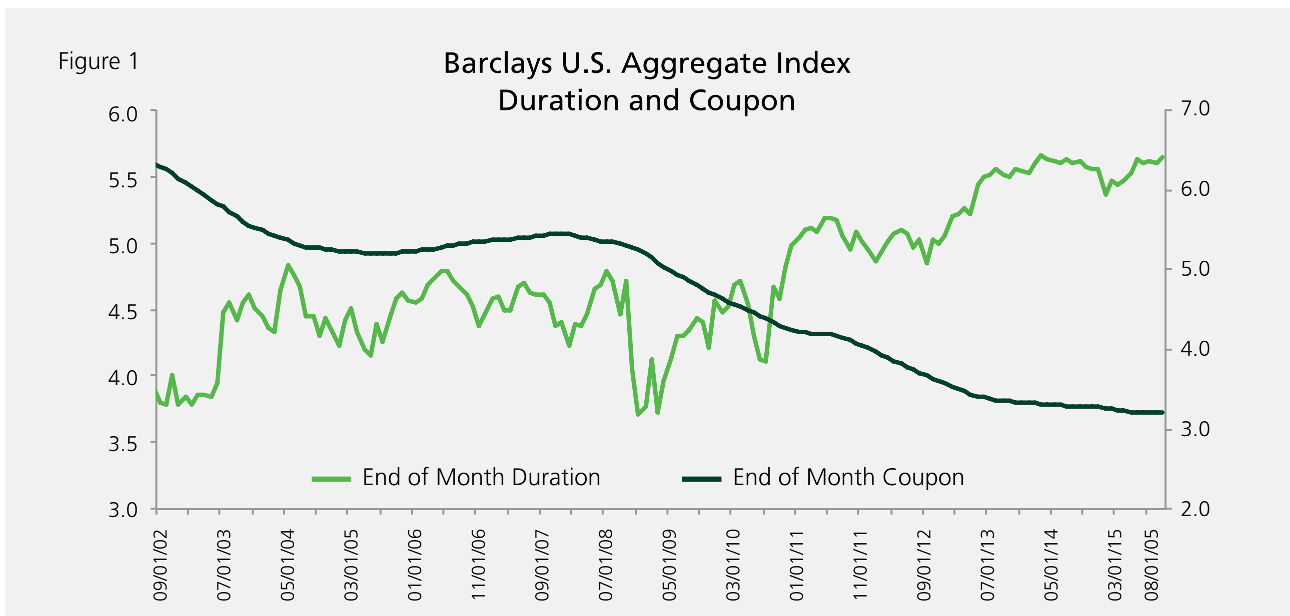
Compounding the problem is the fact that coupons are lower due to the extremely low yields of the last few years. Coupon payments (interest income) tend to be the most stable source of return as they are not affected by changes in the price of a bond, and they provide investors with some protection in a rising rate environment. Income from the coupon payments helps to cushion the impact of weak or negative returns that can result from rising rates, but coupons are low at the moment, so they provide less income to offset any potential further increases in interest rates.

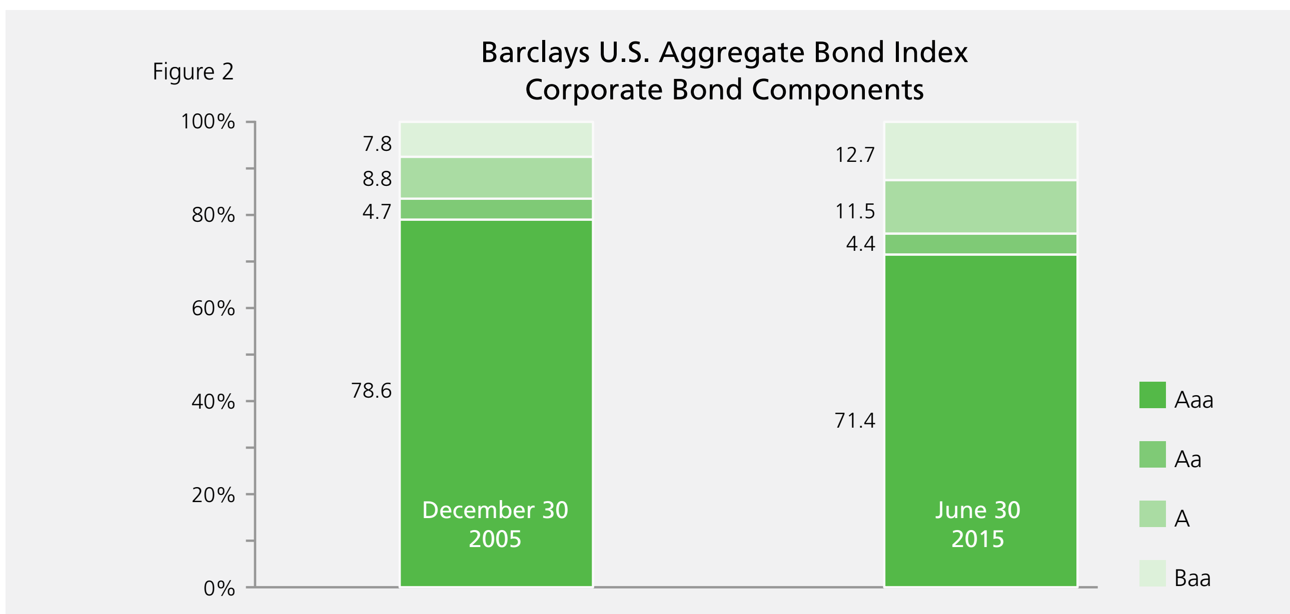
The combination of the Index's higher sensitivity to changes in interest rates and lower coupon payments may present challenges for investors looking to protect capital in their portfolios. To counter this, investors should consider a more flexible approach where the composition of their holdings is not dictated by the Index. Instead, taking an active approach allows investors (or their portfolio managers) to use strategic duration and yield curve positioning to help manage the overall influences of interest rate movements on a portfolio.



Source: Barclays Risk Analytics and Index Solutions Ltd., TD Asset Management

Lower Credit Quality

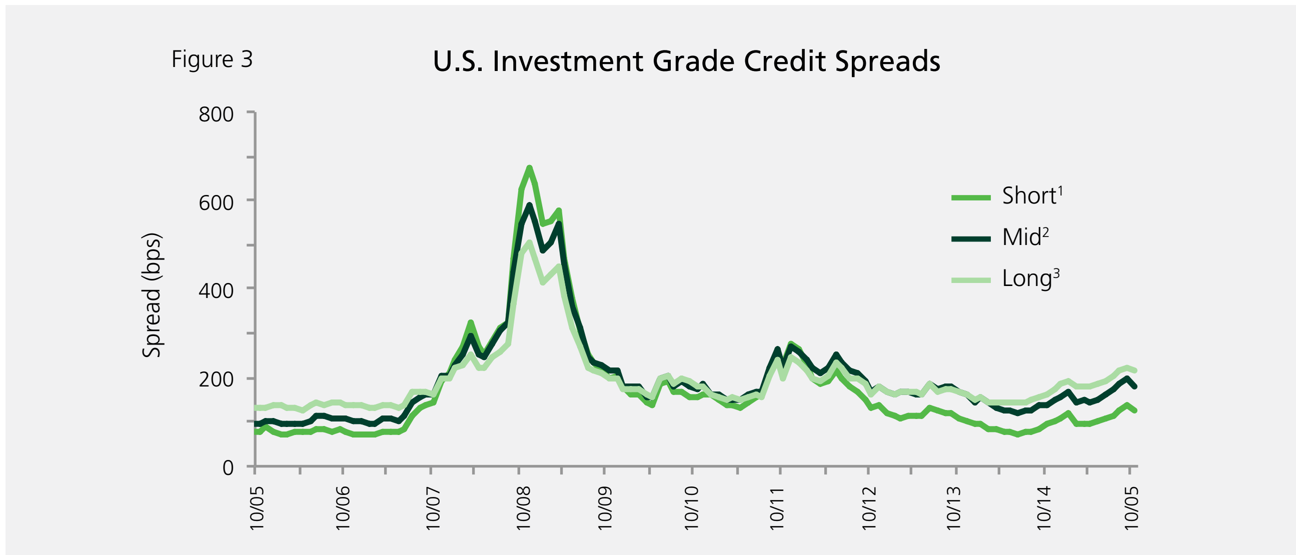
The composition of the benchmark has also changed over past decade. The Index is market weighted, which means the companies that issue the most debt have the highest weights in the Index. This has resulted in a significant increase in the number of triple-B rated bonds (the lowest investment-grade ranking) in the Index (see Figure 2).



Source: Barclays Risk Analytics and Index Solutions Ltd., TD Asset Management

While we believe that corporate credit can add significant value to portfolios, it must be properly managed. For example, investors are currently earning similar spreads on the average long-term corporate bond as they are on the average mid-term corporate bond (Figure 3), which means that investors are not earning additional spread premium for taking on additional maturity risk in corporate bonds.

Unfortunately, because passive investors naturally replicate the Index, in which capital is allocated across terms and sectors, there is little they can do to mitigate credit risk. Conversely, active investing provides the flexibility to take steps to attempt to moderate risks and/or to seek appropriate compensation for any risks undertaken. For example, when adding corporate bonds to TDAM's active fixed income portfolios, each corporate bond is vigilantly researched by our independent credit research team to characterize risks and determine if we are comfortable lending money to an issuer and over what time horizon we would be willing to do so. TDAM's portfolio management team will only invest in a security if they believe it is suitable for the portfolio and the compensation remains adequate given the level of risk. This allows them to make allocations to sectors and companies based upon valuation and credit risk, rather than how much debt a company has issued.



Source: Bloomberg Finance L.P., TD Asset Management. [1]BofA Merrill Lynch 3-5 Year U.S. Corporate Index, [2]BofA Merrill Lynch 7-10 Year U.S. Corporate Index, [3]BofA Merrill Lynch 15+ Year U.S. Corporate Index

Protecting Capital in a Rising Rate Environment

Although the Fed has begun to modestly raise the federal funds rate, we believe it will move slowly and cautiously and expect this to be the loosest tightening cycle in Fed history. Interest rates remain extremely low on an absolute and historical basis, and we believe they will continue to be low for a considerable time. Nonetheless, investors should be thinking about how to position their portfolios to protect capital in a rising rate environment.

There are two primary approaches to help protect portfolios from rising rates:

- Reduce the portfolio's sensitivity to interest rates
- Increase yield, which provides a cushion that can help to offset the impact of rising yields

Given the Index's increased sensitivity to interest rates and lower coupons, it is not ideally positioned for a rising rate environment, and passive investors may find it challenging to meet their goals. On the other hand, active management can utilize both of these approaches to help investors navigate the challenging market environment. For example, to help protect our clients' capital, we have made efforts to reduce our active portfolios' sensitivity to interest rates by:

- Strategically positioning portfolios' interest rate exposure along the yield curve.
- Emphasizing securities that typically provide a higher yield, such as corporate securities. Securities with little or no spread (such as Treasuries) are more sensitive to interest rate changes due to their low coupons, and they are likely to underperform in a rising rate environment. We also believe that, in the event of rising rates driven by economic improvement, credit spreads may tighten, which typically benefits corporate bonds.

Summary

We believe flexibility is required in today's landscape of low yields and potentially higher rates. The current market environment requires a dynamic approach that utilizes diverse strategic and tactical sources of added value. Rather than taking an approach that accepts the inherent risks of the Index, we think investors can benefit from TDAM's actively managed portfolios, which focus on long-term outcomes by helping investors control risks, protect capital and take advantage of opportunities.

TD Asset Management:
This information was prepared by TD Asset Management. The material has been reviewed and is now approved and presented for use in the United States by TD Private Client Wealth, LLC and TD Bank N.A.

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