A FIXED INCOME BALANCING ACT

EXECUTIVE SUMMARY

Financial advisors increased their allocations to fixed income plus sector assets in recent years as they searched for yield and prepared for the impact of rising U.S. interest rates. Our analysis suggests that advisors may not be aware of the full extent of their plus sector exposure and the unintended risks that it could introduce to their client portfolios. As they try to balance competing priorities, we believe advisors should focus on the basics and align their clients’ individual circumstances and objectives with the broader fixed income and equity environments. We can help.

A LARGER ROLE FOR FIXED INCOME PLUS SECTORS...

In response to the 2008–2009 global financial crisis, the Federal Reserve slashed short-term interest rates and marked the beginning of a prolonged period of low economic growth and low interest rates in the U.S. Against a backdrop that weighed heavily on core fixed income investments, many investors searching for yield and performance moved into fixed income plus sectors, including high yield bonds, emerging markets debt, and floating rate bank loans.

Investment advisors followed a similar path and added exposure to higher-yielding plus sectors to generate income for their clients and to prepare their portfolios for the inevitable return of a rising rate environment. As central banks reconcile monetary policy with global economic data, many advisors question how to position fixed income within their models. Our data suggest that advisors’ portfolios, across the risk spectrum, are significantly exposed to plus sector assets.

...CAN AFFECT OVERALL PORTFOLIO RISK, VOLATILITY, AND EFFICIENCY.

How does plus sector exposure affect your model portfolios? Our team of Portfolio Construction specialists looked at 15 years of data for a series of five representative portfolios with varying allocations to equities, core fixed income, and plus sectors. The data suggest that increased exposure to plus sectors increased the portfolios’ volatility risk, particularly in more conservative models geared toward capital preservation. For example, we looked at a portfolio consisting of 40% equities and 60% fixed income, with half of the fixed income sleeve devoted to core and half to plus sectors. Our analysis shows that this relatively conservative 40/60 mix actually behaves more like a portfolio with a 49/51 mix of equities to fixed income in terms of portfolio volatility. Although less pronounced, we also found a significant impact in more aggressive, higher-equity portfolios intended for capital appreciation. In essence, increased allocations to plus sector assets in model portfolios swapped interest rate risk for...
volatility risk more typical of equities. The bottom line for advisors: Your portfolio strategy may not be aligned with reality.

While plus sector assets could result in an unintended—and often undesirable—increase in equity-type risks in more conservative portfolios, they can maximize portfolio efficiency (the highest total return for a given level of risk) in more aggressive models. For example, a portfolio with a 60/40 mix of equities to bonds with plus sectors accounting for half of its fixed income component was more efficient than a 70/30 portfolio with only core fixed income exposure.

WHITHER INTEREST RATES AND EQUITY MARKETS?

Advisors often increased their plus sector exposure to minimize the impact on returns from a rising rate environment. In previous periods when intermediate- and long-term interest rates were rising, our analysis shows that plus sector assets increased the return potential of fixed income portfolios. This is in addition to their long-established yield advantage over more traditional core fixed income.

However, advisors must be aware of the other ways that plus sector assets can transform the broader risk profile of their client portfolios. For instance, plus sector performance is highly correlated to equities, with obvious implications for the perception of stability and safety traditionally associated with fixed income assets. Additionally, diversification into emerging markets bonds, for example, adds a host of political, economic, and currency risks not typically shared by core fixed income.

Plus sector exposure could carry opportunity costs as well. Plus sectors trailed stock returns in prior equity bull markets and offered less downside mitigation potential than core fixed income during equity bear markets. While plus sectors can outperform core in a rising rate environment, they tend to underperform when rates are falling.

WHAT SHOULD ADVISORS CONSIDER?

We believe a risk-aware approach that balances exposure to plus sectors, core fixed income, and equities can help advisors keep their portfolios aligned with the individual needs and objectives of their clients. As a general rule, T. Rowe Price’s research suggests that 70% of total fixed income exposure in advisors’ models be dedicated to core assets as a counterweight to the models’ equity exposures in order to minimize portfolio risk and maximize risk-adjusted returns. The remaining 30% may be allocated to a mix of strategies, including plus sectors, to be adjusted dynamically depending on a model’s equity exposure. In lower-equity models, advisors could diversify duration risk through a mix of plus sector strategies. In higher-equity models, duration could help diversify or counterbalance pure equity risk.

Acknowledging that managing these considerations can be as much as science, we can help. Contact your T. Rowe Price representative, and our Portfolio Construction specialists will perform an in-depth analysis of your portfolios to help you ensure that they maximize your clients’ opportunities for financial success.

FIGURE 2 Portfolio Considerations

WHAT’S YOUR PRIORITY?

<table>
<thead>
<tr>
<th>Core</th>
<th>Plus</th>
</tr>
</thead>
<tbody>
<tr>
<td>More Stability</td>
<td>More Income</td>
</tr>
<tr>
<td>Less yield</td>
<td>More yield</td>
</tr>
<tr>
<td>Worse performance amid rising rates</td>
<td>Better performance amid rising rates</td>
</tr>
<tr>
<td>Lower equity correlation</td>
<td>Higher equity correlation</td>
</tr>
<tr>
<td>Fewer downside risks</td>
<td>Greater downside risks</td>
</tr>
</tbody>
</table>

The image is for illustrative purposes only. Investment outcomes are not guaranteed. Results will vary.

WE CAN HELP

Contact your T. Rowe Price representative, and our Portfolio Construction specialists will perform an in-depth analysis of your portfolios to help you ensure that they maximize your clients’ opportunities for financial success.

Important Information

Core vs. Plus Fixed Income: Core and Plus are terms used in the investments industry to describe two types of fixed income investment strategies. Core generally refers to fixed income investment strategies that focus on investment grade corporate and government bonds. A Plus strategy adds additional fixed income sectors like high yield bonds, emerging market bonds, and floating rate bank loans in an attempt to improve income or return potential in exchange for a higher risk profile.

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