# Fixed Income Investing

# Stocks and Bonds Are Conduits for Capital


- The stock and bond markets are an important source of capital for public companies.
- Stockholders are equity owners in the company. Bondholders are lenders to a company.
- Both expect an adequate return for the terms and risk of their investment.

# What is Fixed Income?

- Fixed income broadly refers to those types of investment securities that pay investors fixed interest or dividend payments until a maturity date. At maturity, investors are repaid the principal amount invested.
- The term ‘fixed income’ is often used interchangeably with ‘bonds.’
- A bond is a loan to an institution that is obligated to pay you back with interest at a prespecified future date
- The owner of a bond is a creditor.
- The issuer of a bond is a debtor.

# How big is the bond market?

- As of 2017, the size of the worldwide bond market (total debt outstanding) is estimated at $100.13 trillion, according to Securities Industry and Financial Markets Association (SIFMA).
- The global credit market in aggregate is about 3 times the size of the global equity market.

*I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a 400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody.*

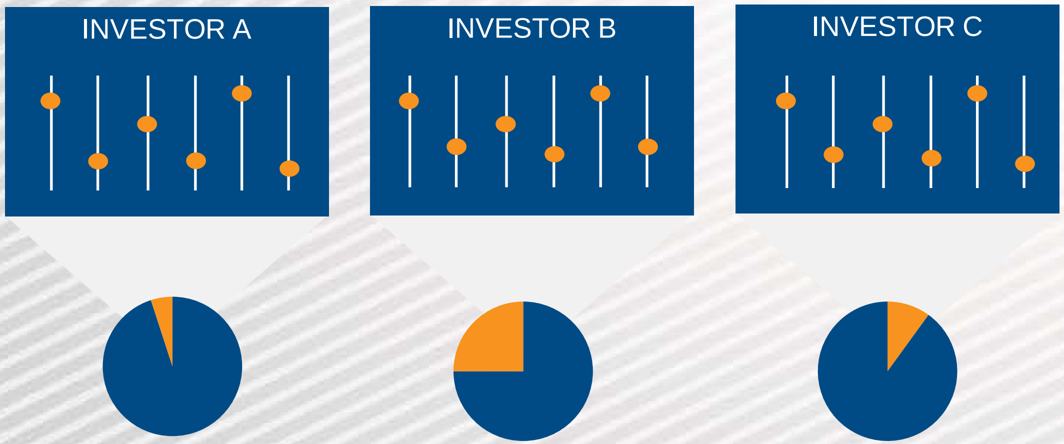
*–James Carville*

# Fixed Income's Role in Portfolios

**FIXED INCOME PLAYS MANY ROLES**

- Reduce Volatility
- Liquidity
- Income
- Inflation Protection
- Tax Sensitivity

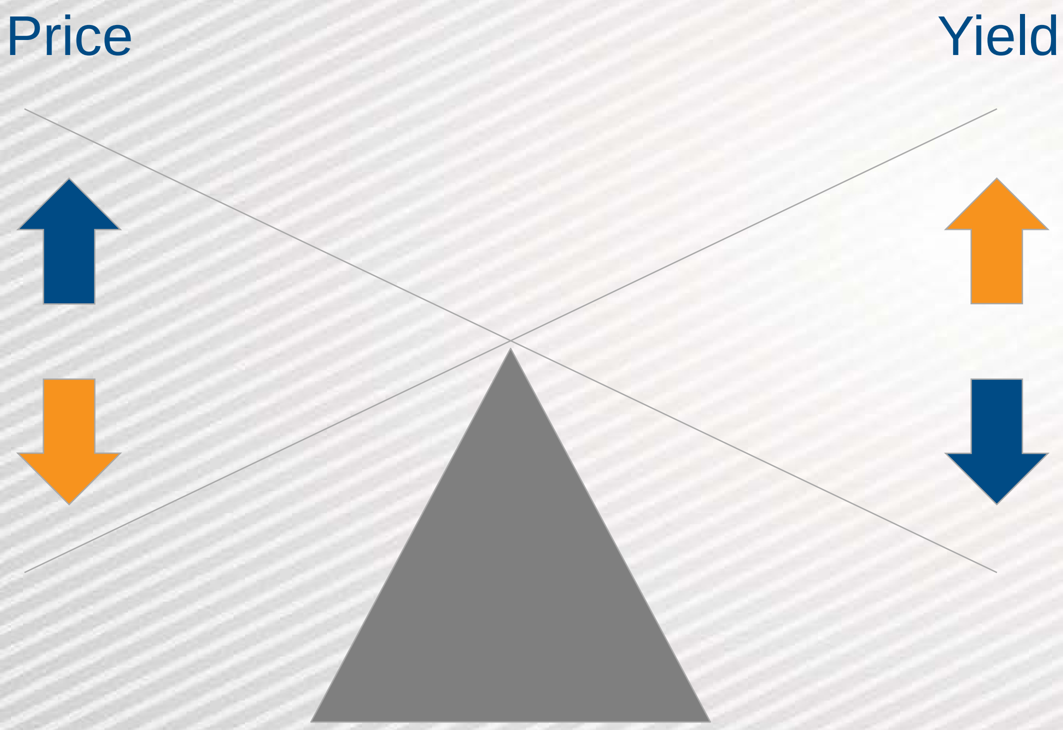
**DIFFERENT INVESTORS HAVE DIFFERENT NEEDS**




- Fixed income can play many different roles in a portfolio.
- Fixed income portfolios can be customized to meet the needs of investors.
- A financial planner can help determine what type of and how much fixed income is right for your investment goals.

Fixed income portfolios are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks, including changes in credit quality, liquidity, prepayments, call risk, and other factors. Inflation-protected securities may react differently from other fixed income securities to changes in interest rates.
Municipal securities are subject to the risks of adverse economic and regulatory changes in their issuing states. There is no assurance that any investment objective will be met. Investing involves risks, including possible loss of principal.

# Prices and Yields




- There is an inverse relationship between the price of a bond and the yield of a bond.
- As the yield of a bond increases, its price will decrease. And as the yield of a bond decreases, its price will increase.

# Components of a Bond

- Issuer (Credit Rating)
- Coupon (Rate, Frequency)
- Price
- Maturity Date (Duration)
- Optionality or Call Features
- Yield to Maturity

- Credit Risk
- Interest Rate Risk
- Pre-Payment Risk
- Reinvestment Risk
- Currency Risk
- Inflation Risk
- Liquidity Risk

# Components of a Bond Yield

| | | NOMINAL CORPORATE OR MUNICIPAL BOND | TREASURY BOND | TREASURY INFLATION-PROTECTED SECURITY |
|---|---|---|---|---|
| TERM | REAL RATE COMPONENT | Real Rate + Real Term Premium | Real Rate + Real Term Premium | Real Rate + Real Term Premium |
| | | + | + | |
| | INFLATION COMPONENT | Expected Inflation + Inflation Risk Premium | Expected Inflation + Inflation Risk Premium | |
| | | + | | |
| CREDIT | | Credit Premium | | |

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# Fixed Income Approaches

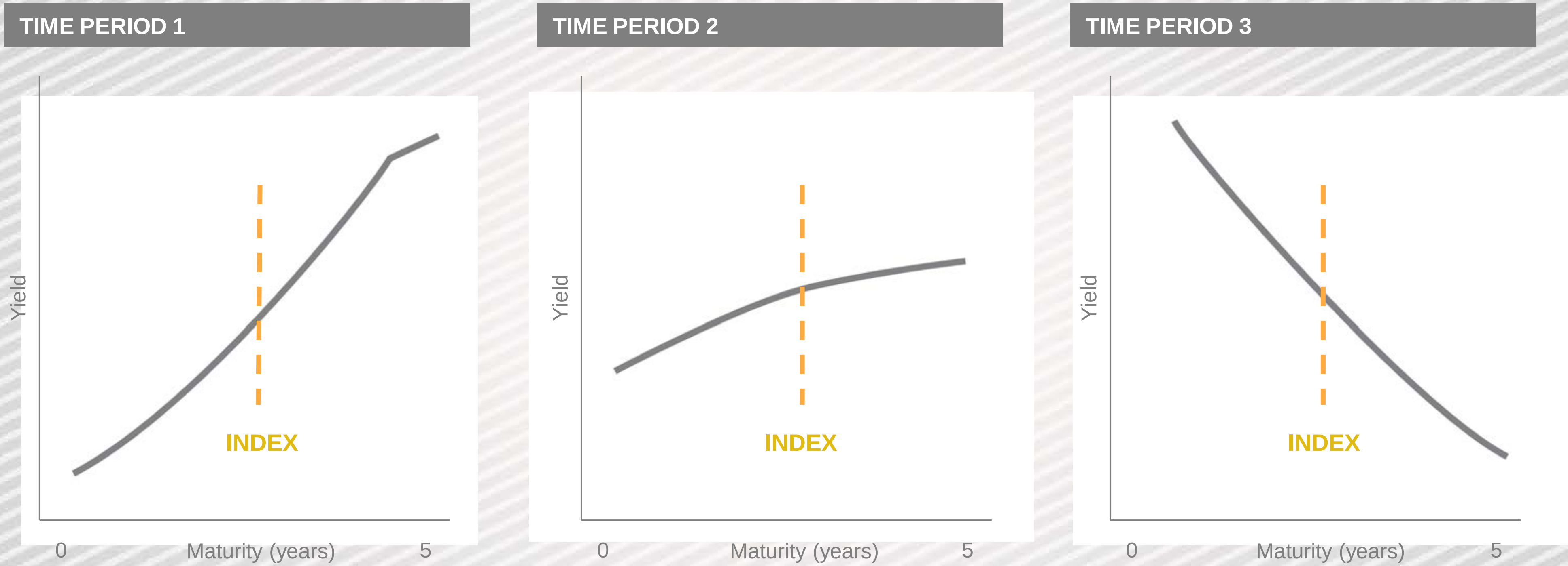
# Different Approaches to Fixed Income Investing

| CONVENTIONAL MANAGEMENT |
| --- |
| Attempts to identify mispricing in bonds |
| Relies on prediction to select “undervalued” bonds or time the direction of interest rates |
| Generates higher expenses, trading costs, and risks |

# Different Approaches to Fixed Income Investing

| INDEX MANAGEMENT |
|---|
| Allows commercial index to determine strategy |
| Attempts to match index performance, restricting which bonds to hold and when to trade |
| Prioritizes low tracking error over higher expected returns |

# An Index Approach Lacks Flexibility




- Index managers will attempt to match the maturity of the benchmark regardless of the yield curve's current shape.
- This approach prioritizes tracking the index over targeting higher expected returns.

For illustrative purposes only.

# Different Approaches to Fixed Income Investing

| AN ALTERNATIVE APPROACH |
| --- |
| Gains insights about fixed income markets and expected returns from academic research |
| Uses information in current yield curves to adjust portfolio to target higher expected returns |
| Adds value by integrating research, portfolio design, portfolio management, and trading |

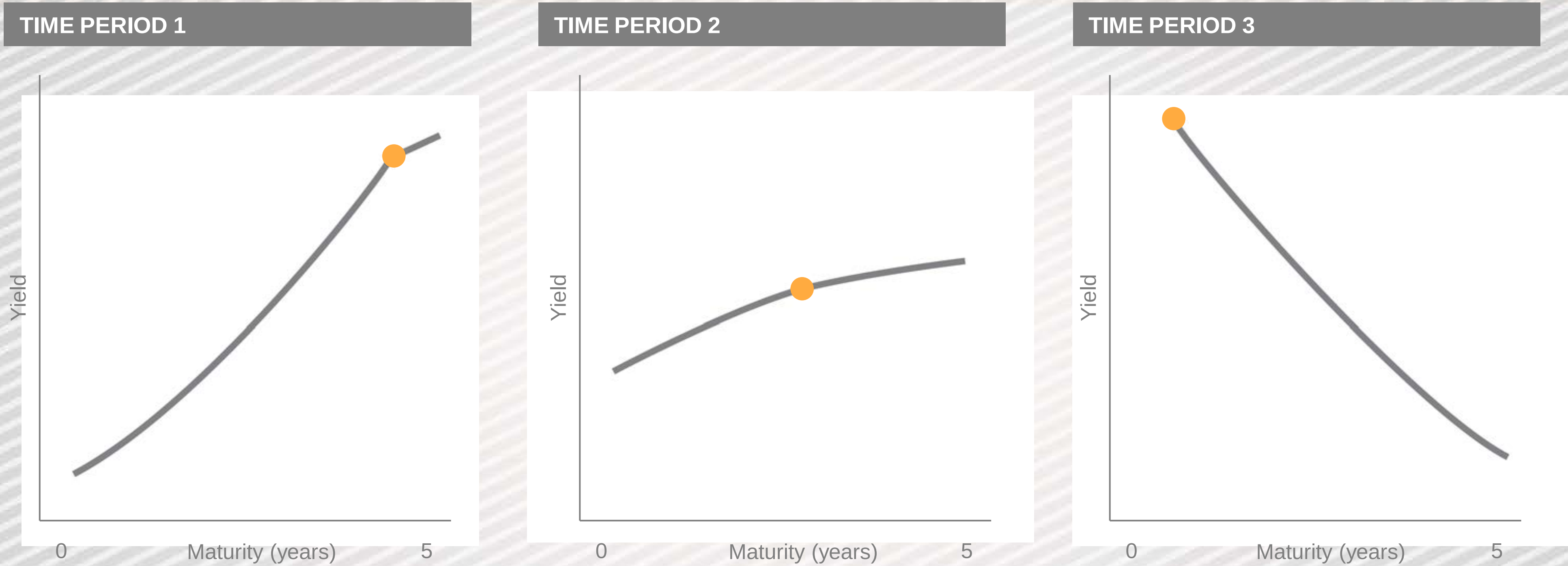
# Drivers of Expected Returns in Fixed Income Markets

**Duration** | **Credit Quality** | **Currency**

- Market prices tell us about the risk and return of bonds, which we can group along certain dimensions such as duration, credit quality, and the currency in which the bond is issued.
- Investors can impact the risk and return potential of their fixed income investments through the types of bonds included in their portfolios.

# Duration and Credit Quality

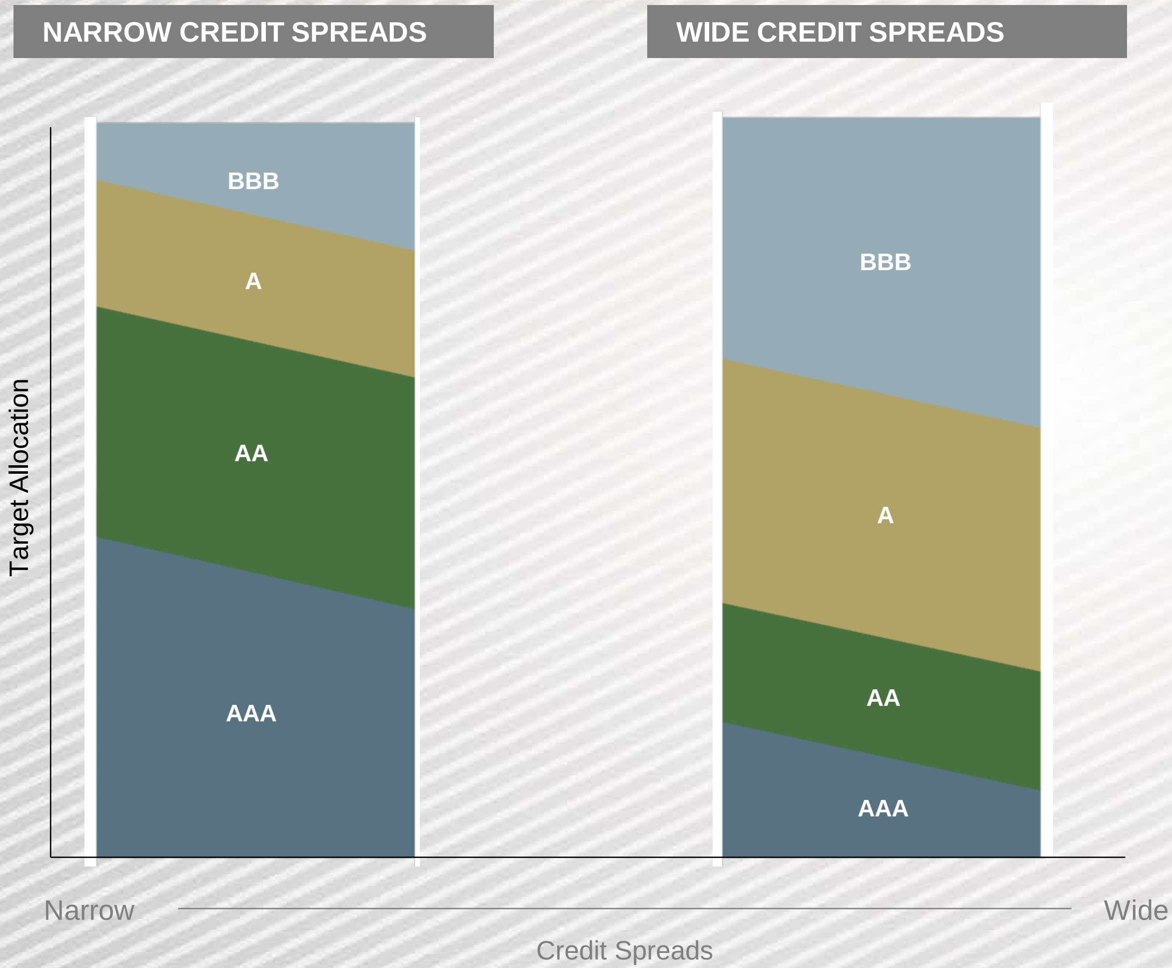
# Vary Portfolio Duration to Pursue Higher Expected Returns




- The level and shape of yield curves tell us about the expected returns of different bonds.
- Because yield curves change through time, the bonds that offer the highest expected returns through time also change.
- A flexible, market-based approach can invest in these bonds to improve the expected return of a bond portfolio over a fixed or index-based approach.

**Investing involves risks, including possible loss of principal. There is no guarantee that any strategy will be successful.**
For illustrative purposes only.

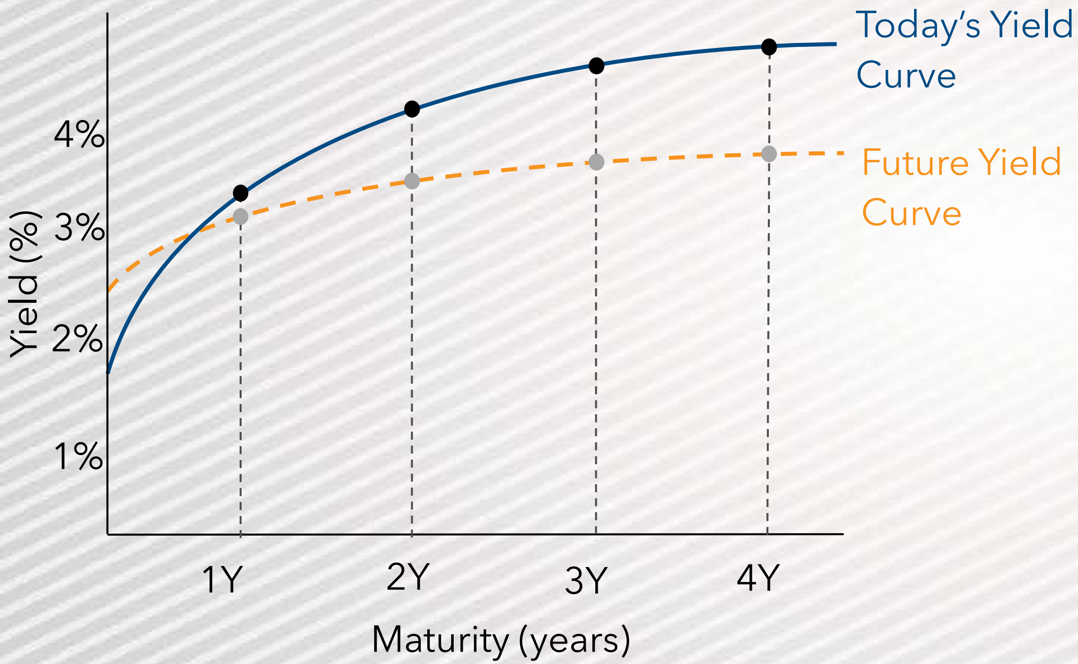
# Vary Portfolio Credit Quality to Pursue Higher Expected Returns




- Narrow credit spreads generally lead to lower credit premiums. In this case, increasing the allocation to higher credit quality bonds can increase expected returns
- Wide credit spreads generally lead to higher credit premiums. In this case, increasing allocation to lower credit quality bonds can enhance expected returns.

**Investing involves risks, including possible loss of principal. There is no guarantee that any strategy will be successful.**
For illustrative purposes only. Wide spreads defined as when month-begin spreads are greater than the median spread. Narrow spreads defined as when month-begin spreads are less than the median spread.

# Yield Curves Change Through Time



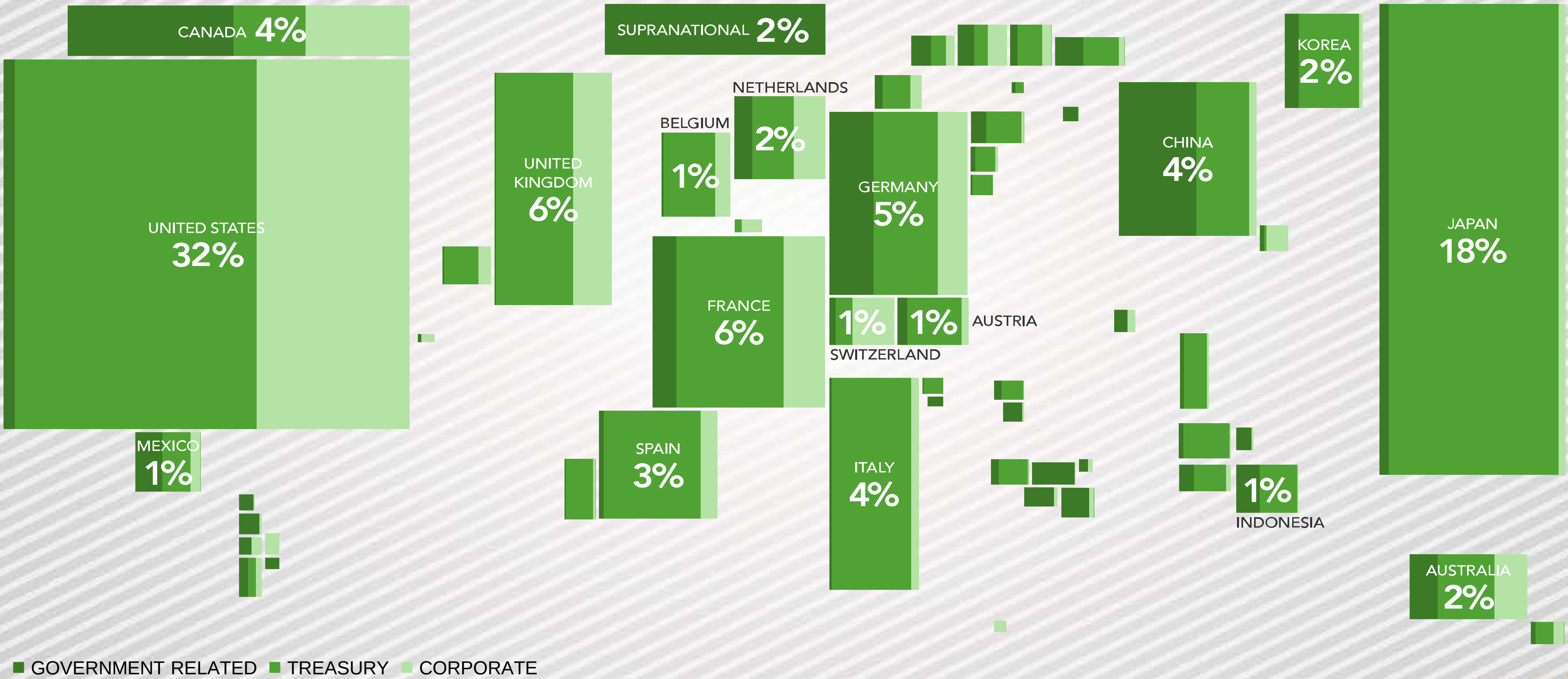

- A yield curve is a collection of yields for bonds of different maturities.
- As new information enters the market or investors' tastes and preferences change, yield curves can change.
- Global diversification may help investors reduce volatility from yield curve movements.

**Diversification does not assure a profit or protect against loss. International and emerging markets investing involves special risks, such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks.**

# Currency

# There's a World of Opportunity in Fixed Income

## Percent of global investment grade bond market as of December 31, 2019




Data is from Bloomberg Barclays Global Aggregate Ex-Securitized Bond Index. Index excludes non-investment grade securities, bonds with less than one year to maturity, tax-exempt municipal securities, inflation-linked bonds, floating rate issues and securitised bonds. Government Related is a combination of agency, local government and non-corporate credit bonds. Many nations not displayed. Totals may not equal 100% due to rounding. For educational purposes; should not be used as investment advice. Data provided by Bloomberg.

# Global Bonds Can Enhance Diversification

**CHANGES IN SHORT-TERM YIELDS: CORRELATIONS WITH THE US**

| | Australia | Canada | Switzerland | Germany/EMU | UK | Japan |
|---|---|---|---|---|---|---|
| 1985–2019 | 0.29 | 0.62 | 0.31 | 0.45 | 0.36 | 0.25 |

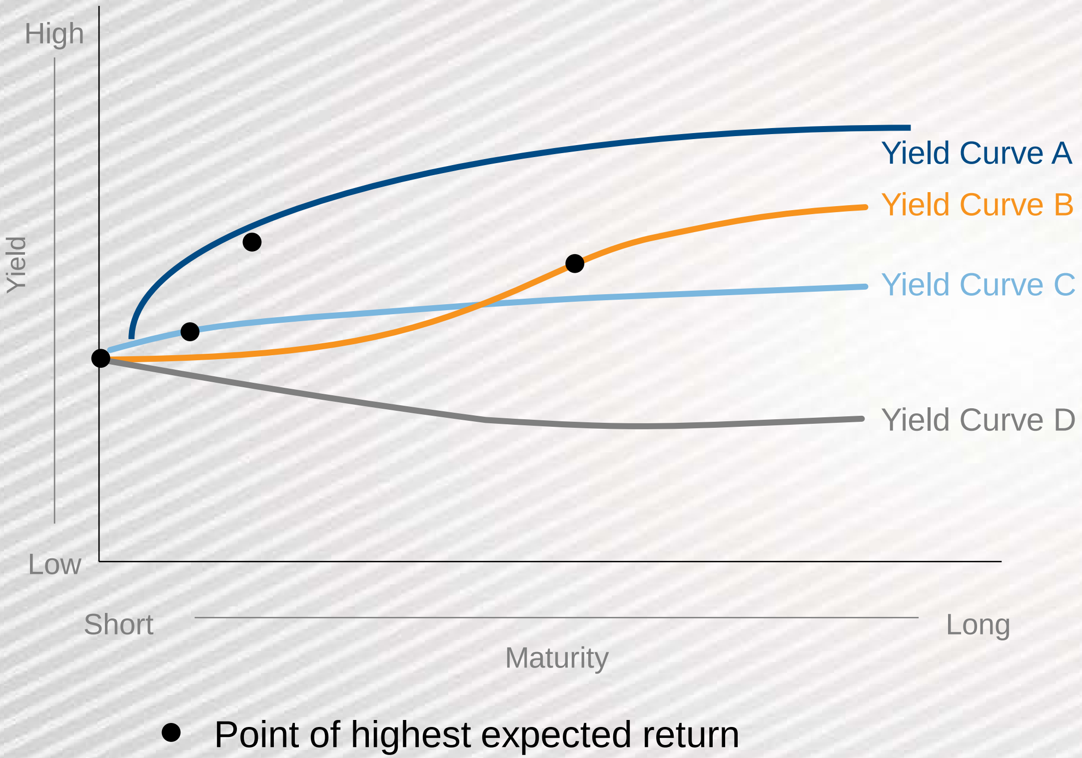
**1–3 YEAR INDICES: 1985–2019**

| | US | WGBI (hedged to USD) |
|---|---|---|
| Avg. Returns (monthly) | 0.39% | 0.39% |
| Std. Dev. (monthly) | 0.52% | 0.40% |
| Reduction in Volatility | — | 22% |

- Since yields across countries do not move in lock-step, investors can reduce expected volatility by diversifying across yield curves using global bonds.

**Past performance is no guarantee of future results. Diversification does not assure a profit or protect against loss. International and emerging markets investing involves special risks, such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks.**
Non-US individual country returns represented by FTSE WGBI Unhedged Indices (1–3 Years). US bond returns represented by the FTSE US Government Bond Index (1–3 Years). Aggregate world government bond returns represented by the FTSE WGBI USD Index (1–3 Years). Correlations of short-term yield changes are based on unhedged yields. US average monthly return based on Dimensional calculation of FTSE WGBI US 1-3 year index data. WGBI (hedged) average monthly return based on WGBI 1-3 year index (hedged to USD). FTSE fixed income indices  Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Standard deviation measures volatility.

# Global Bonds Can Enhance Expected Returns




- Global yield curves may exhibit different shapes at different points in time, offering a broader opportunity set.
- By expanding the opportunity set, investors can target higher expected returns in different yield curves around the world.

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For illustrative purposes only.

# Appendix

**How much impact does the President have on the market?**

- https://www.dimensional.com/us-en/insights/how-much-impact-does-the-president-have-on-stocks


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**Complimentary Retirement Assessment**

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1. Complete our Survey
2. Set a Getting Acquainted Call
3. We'll Build You a Personalized Asset Map

# Reading List

The Handbook of Fixed Income Securities by Frank Fabozzi

Lords of Finance by Liaquat Ahamed

The Creature from Jekyll Island by E. Edward Griffin

The Intelligent Investor by Benjamin Graham

Against the Gods by Peter L. Bernstein

Principles by Ray Dalio

Fooled by Randomness by Nassim Taleb

**Modern Day Financial Follies**

- When Genius Failed by Roger Lowenstein
- Griftopia by Matt Taibbi
- Bailout Nation by Barry Ritholtz

# Disclosures

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RISKS

Investments involve risks. The investment return and principal value of an investment may fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original value. Past performance is not a guarantee of future results. There is no guarantee strategies will be successful.

The returns of Dimensional indices presented herein reflect hypothetical performance and do not represent returns that any investor actually attained. Changes in the assumptions upon which such performance is based may have a material impact on the hypothetical returns presented. Hypothetical backtested returns have many limitations. Unlike actual performance, it does not represent actual trading. Since trades have not been actually executed, results may have under-or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity, and may not reflect the impact that certain economic or market factors may have on the decision-making process. Hypothetical backtested performance is also developed with the benefit of hindsight. Other periods selected may have different results, including losses. There can be no assurance that Dimensional will achieve profits or avoid incurring substantial losses.

All charts are for illustrative purposes only and is not indicative of any investment. Performance may increase or decrease as a result of currency fluctuations.

Small cap securities are subject to greater volatility than those in other asset categories.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates and may be subject to various other risks, including changes in credit quality, liquidity, prepayments, and other factors.

International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks. Sector-specific investments can also increase investment risks.