

“It’s Your Money”

Fixed Income Investing

November 2021



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What is “fixed income”?

- It's a LOAN
- You're giving money to someone for some period of time hoping to be paid back and receive more than you started
- Most commonly you are loaning money and receiving interest until your principal is returned

Fixed Income Examples

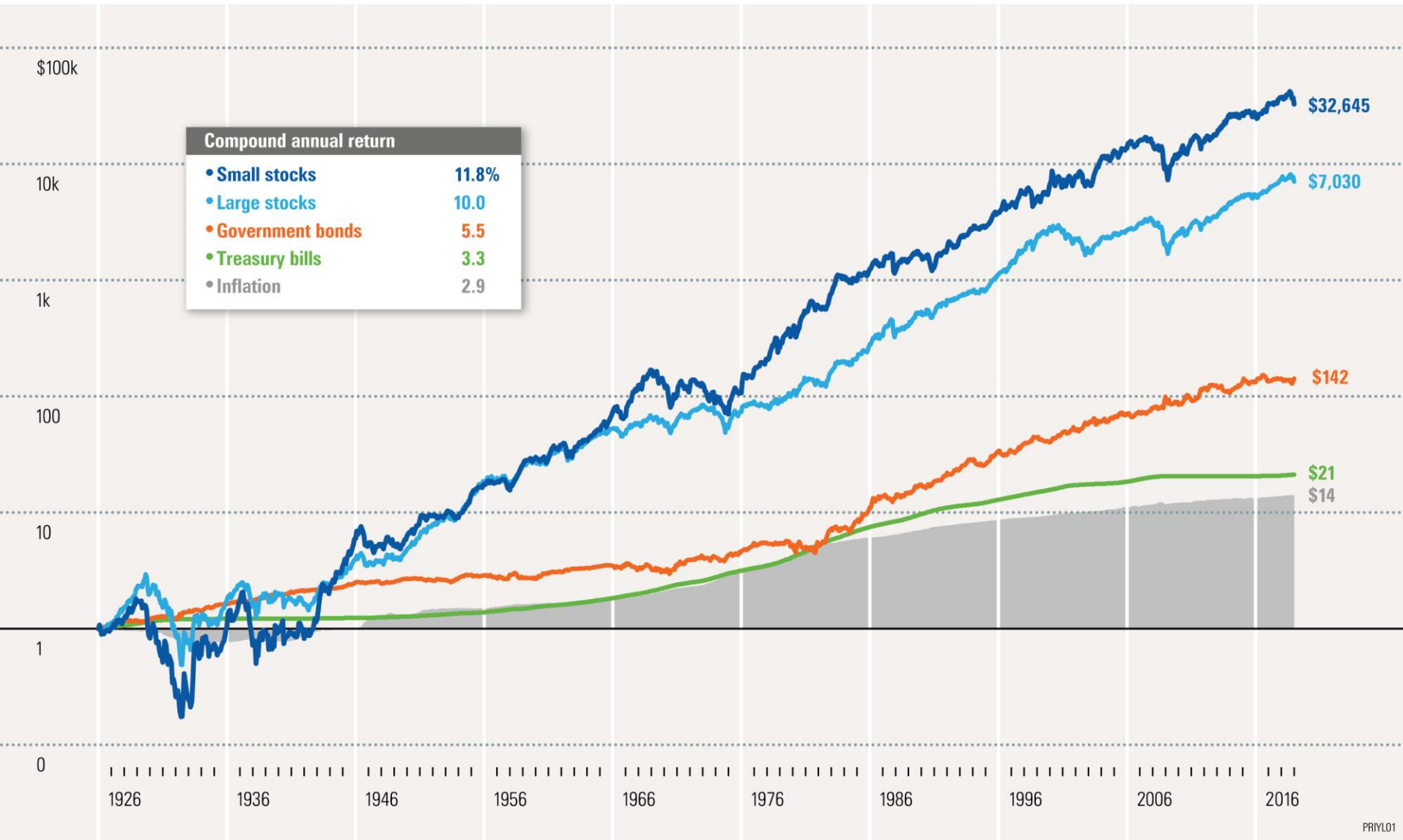
- CDs (Certificates of Deposit)
- US Treasuries
- Municipal (“Muni”) Bonds
- Corporate Bonds
- Mortgage Backed Bonds
- International Bonds

Benefits of Fixed Income

- Dependable income
 - Periodic payments
 - Most are semi-annual
 - Can be monthly, annually, none (“zero coupon”)
 - Higher yield than cash and inflation
 - Averaging 2.5% to 3% above inflation rate
 - Long-term returns have averaged 5.5% to 6%
- Complement to other investments
 - Provide downside protection
 - Typically act counter-cyclically to stocks

Ibbotson® SBBI®

Stocks, bonds, bills, and inflation 1926–2018



Past performance is no guarantee of future results. Hypothetical value of \$1 invested at the beginning of 1926. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. © Morningstar. All Rights Reserved.



Risk Determines Expected Return

- Credit (“default”) risk - *Will I get paid?*
- Inflation risk – *Will my bond return keep up with inflation?*
- Interest rate (“price”) risk – *Will interest rate moves reduce the price of my bond?*
- Re-investment risk – *Will I be reinvesting at lower interest rates?*
- Other risks: liquidity risk, currency risk, downgrade risk

Risk Determines Expected Return

- Examples:
 - 1-Year CD has no default risk; little inflation risk; no interest rate risk; little reinvestment risk so the expected return will be quite low (0.2% to 0.5%)
 - 10-year Treasury Note has no default risk; some inflation risk; some interest rate risk; some reinvestment risk so the expected return will be relatively low (1.5% to 2.0%)

Risk Determines Expected Return

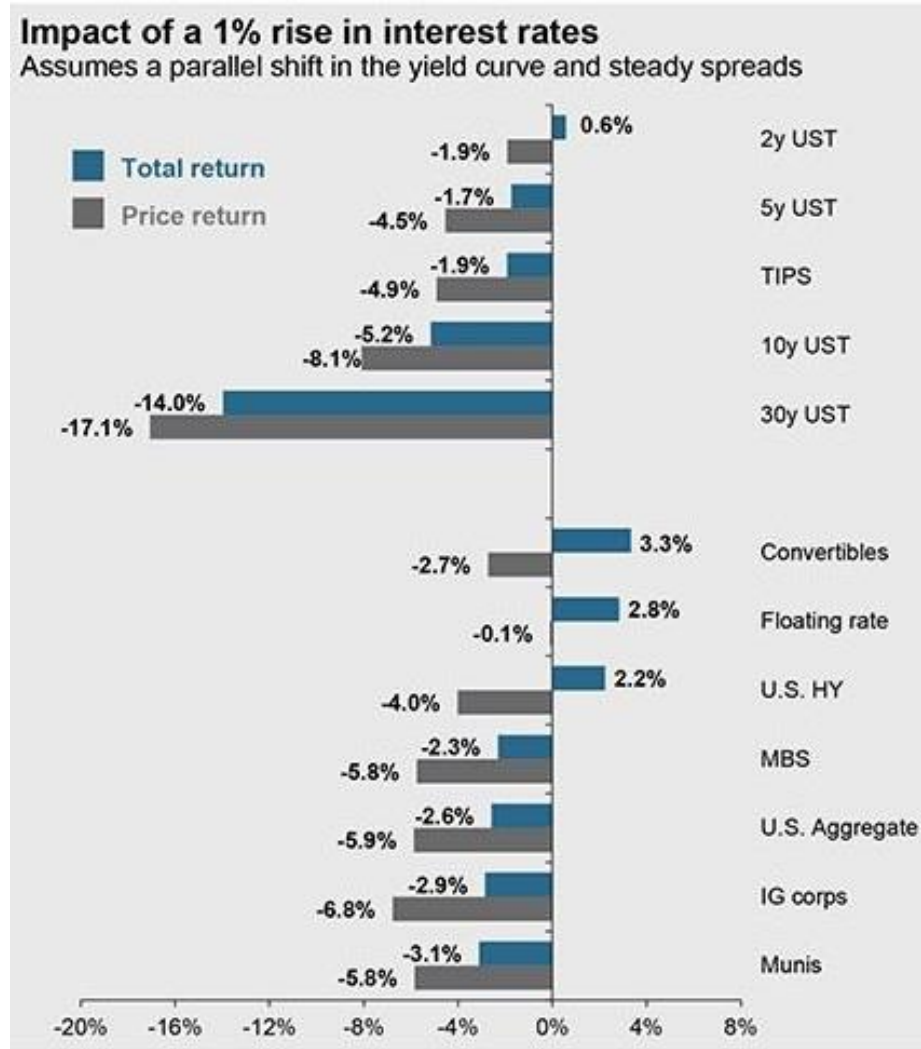
- Examples:
 - 10-year Citigroup bond has little default risk; some inflation risk; some interest rate risk; some reinvestment risk so the expected return will be low (2.5% to 3.0%)
 - 5-year unsecured loan to my brother has lots of default risk; some inflation risk; some interest rate risk; some reinvestment risk so the expected return should be high (12% to 18%)

Interest Rates and Price Move In Opposite Directions

- When interest rates rise, bond prices fall
- When interest rates fall, bond prices rise

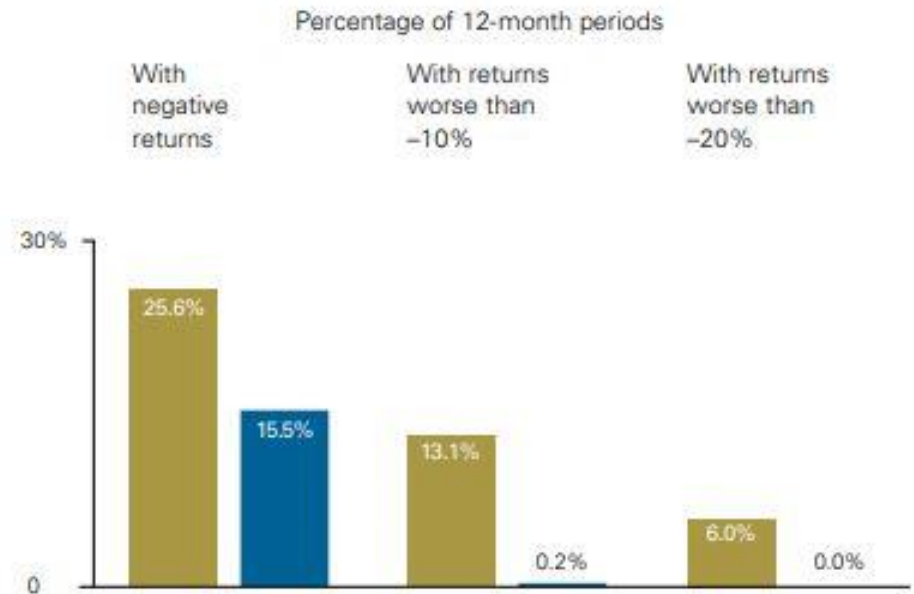
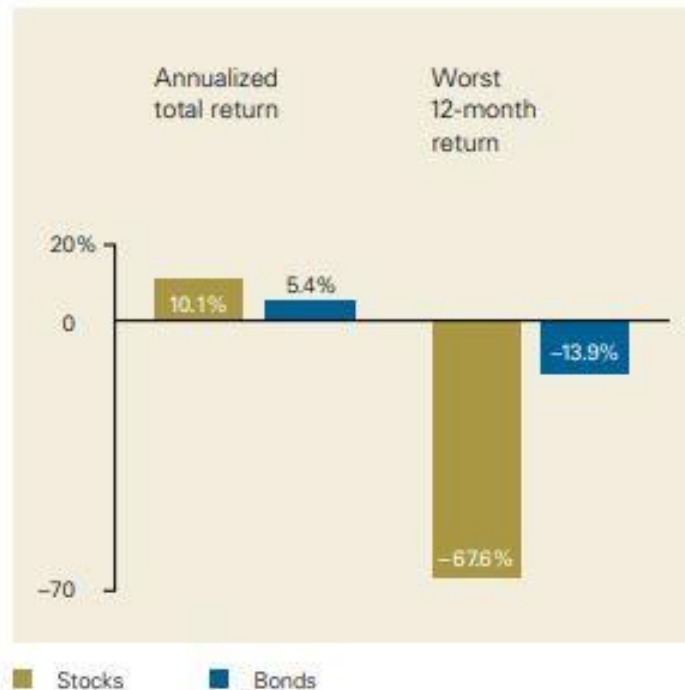


Bonds Can Go Down In Value



Bonds Are Safer Than Stocks

U.S. financial markets, 1926–2017



Be Wary of Bond “Alternatives”

- Investors have moved to bond alternatives, but these often add substantial risk to an investment portfolio

Asset Class	2008 Return
Total Bond Market	+5%
Dividend Paying Stocks	-23%
High Yield Bonds	-26%
Master Limited Partnerships	-37%
Real Estate Investment Trusts	-38%
Commodities	-48%

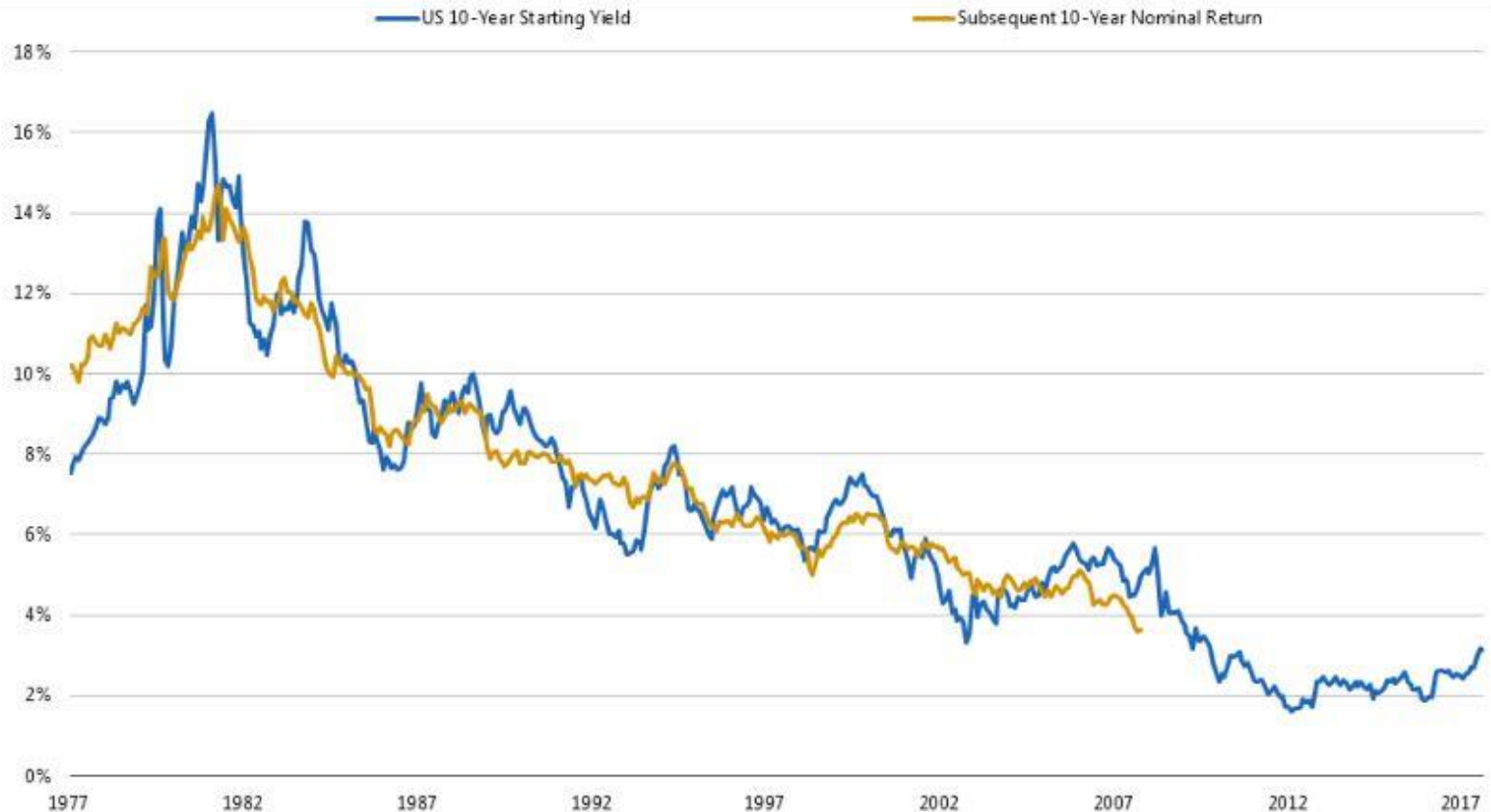
Bonds Are Diverse

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD	Ann.
EMD LCL. 23.0%	EMD USD 10.2%	EMD LCL. 15.2%	EMD LCL. 18.1%	Treas. 13.7%	High Yield 58.2%	EMD LCL. 15.7%	TIPS 13.6%	EMD USD 17.4%	High Yield 7.4%	Muni 8.7%	Muni 3.8%	High Yield 17.1%	EMD LCL. 15.2%	Muni 1.4%	Corp. 13.2%	EMD USD 7.0%
EMD USD 11.6%	EMD LCL. 6.3%	High Yield 11.8%	TIPS 11.6%	MBS 8.3%	EMD USD 29.8%	High Yield 15.1%	Muni 12.3%	EMD LCL. 16.8%	MBS -1.4%	Corp. 7.5%	MBS 1.5%	EMD USD 10.2%	EMD USD 10.3%	MBS 1.0%	EMD USD 13.0%	High Yield 7.0%
High Yield 11.1%	Asset Alloc. 3.1%	EMD USD 9.9%	Treas. 9.0%	Barclays Agg 5.2%	EMD LCL. 22.0%	EMD USD 12.2%	Treas. 9.8%	High Yield 15.8%	Corp. -1.5%	EMD USD 7.4%	EMD USD 1.2%	EMD LCL. 9.9%	High Yield 7.5%	Treas. 0.9%	High Yield 11.4%	EMD LCL. 5.9%
TIPS 8.5%	TIPS 2.8%	Asset Alloc. 5.7%	Barclays Agg 7.0%	Muni 1.5%	Corp. 18.7%	Corp. 9.0%	Corp. 8.1%	Corp. 9.8%	Asset Alloc. -1.9%	MBS 6.1%	Treas. 0.8%	Corp. 6.1%	Corp. 6.4%	Barclays Agg 0.0%	Asset Alloc. 8.9%	Asset Alloc. 4.8%
Asset Alloc. 6.6%	Treas. 2.8%	MBS 5.2%	MBS 6.9%	Asset Alloc. 0.1%	Asset Alloc. 14.7%	Asset Alloc. 7.9%	Asset Alloc. 8.1%	Asset Alloc. 7.4%	Barclays Agg -2.0%	Barclays Agg 6.0%	Barclays Agg 0.5%	Asset Alloc. 4.7%	Muni 5.8%	Asset Alloc. -0.7%	Barclays Agg 8.5%	Corp. 4.6%
Corp. 5.4%	Muni 2.7%	Muni 4.7%	Asset Alloc. 6.7%	TIPS -2.4%	TIPS 11.4%	Barclays Agg 6.5%	Barclays Agg 7.8%	TIPS 7.0%	Muni -2.2%	Asset Alloc. 5.5%	Asset Alloc. -0.3%	TIPS 4.7%	Asset Alloc. 5.3%	TIPS -1.3%	EMD LCL. 7.9%	Muni 4.4%
MBS 4.7%	High Yield 2.7%	Barclays Agg 4.3%	EMD USD 6.2%	Corp. -4.9%	Muni 9.9%	TIPS 6.3%	EMD USD 7.3%	Muni 5.7%	Treas. -2.7%	Treas. 5.1%	Corp. -0.7%	Barclays Agg 2.6%	Barclays Agg 3.5%	High Yield -2.1%	Treas. 7.7%	MBS 3.9%
Barclays Agg 4.3%	MBS 2.6%	Corp. 4.3%	Corp. 4.6%	EMD LCL. -5.2%	Barclays Agg 5.9%	Treas. 5.9%	MBS 6.2%	Barclays Agg 4.2%	EMD USD -5.3%	TIPS 3.6%	TIPS -1.4%	MBS 1.7%	TIPS 3.0%	Corp. -2.5%	TIPS 7.6%	Barclays Agg 3.9%
Muni 4.1%	Barclays Agg 2.4%	Treas. 3.1%	Muni 4.3%	EMD USD -12.0%	MBS 5.9%	MBS 5.4%	High Yield 5.0%	MBS 2.6%	TIPS -8.6%	High Yield 2.5%	High Yield -4.5%	Treas. 1.0%	MBS 2.5%	EMD USD -4.3%	Muni 6.9%	TIPS 3.8%
Treas. 3.5%	Corp. 1.7%	TIPS 0.4%	High Yield 1.9%	High Yield -26.2%	Treas. -3.6%	Muni 4.0%	EMD LCL. -1.8%	Treas. 2.0%	EMD LCL. -9.0%	EMD LCL. -5.7%	EMD LCL. -14.9%	Muni -0.1%	Treas. 2.3%	EMD LCL. -6.2%	MBS 5.6%	Treas. 3.5%

Bond Interest Rate Tells You Little About Total Return

- Many individual bonds are not purchased “at par” (at their origination)
- Price of bond matters to determine total return
- For example:
 - 10-Year Bond With 5% Coupon Purchased at 100 (Par) will have a total return of 5% over its life
 - If purchased at 110, total return drops to 3.8%
 - If purchased at 90, total return increases to 6.4%
- “Yield to maturity” and “yield to call” are better measures

Bond Returns Are Predictable – They'll Be Low Going Forward



As of 30 March 2018. SOURCE: Bloomberg 10-Year Yields based on Barclays US Agg Total Return Value Unhedged USD.
Past performance is not a guarantee or a reliable indicator of future results. It is not possible to invest directly in an unmanaged index.

PIMCO

U.S. Core Bonds: Starting Yield vs. Subsequent 10-Yr Returns

Municipal Bonds?

- “Munis” are typically called tax-free bonds, interest on these bonds can be:
 - Free from federal taxes
 - Free from state taxes
 - Free from both federal and state taxes
- Interest rates for these bonds is typically lower, but the “after-tax” rate can be higher than taxable bonds
- Example: Scott owns a federal and state exempt municipal bond paying 5%.
 - If Scott is in the 12% combined tax brackets, he would have to own a taxable bond paying 5.6% to be ahead.
 - If Scott is in the 47% combined tax brackets, he would have to own a taxable bond paying 9.4% to be ahead.

Buying Individual Bonds

- No central exchange
- Bonds are generally bought and sold through brokerage firms
- Quotes can vary significantly from broker to broker
- No transparency (commissions are built into the bond pricing)

Buying Individual Bonds

- Advantages:
 - Can be held to maturity
 - Can be “laddered” to match cashflow needs
- Disadvantages:
 - Difficult to diversify
 - Expensive to buy/sell
 - Research is necessary

Buying Bond Mutual Funds

- Bond funds come in all types:
 - Different maturity ranges:
 - ultra-short
 - short-term
 - intermediate-term
 - long-term
 - Different sectors:
 - “Total Return”
 - Government
 - Corporate
 - High yield
 - Inflation protected
 - Municipal
 - International
 - Emerging market

Buying Bond Mutual Funds

■ Advantages:

- Well diversified
- Professionally managed
- Easy to buy and sell – fair pricing

■ Disadvantages

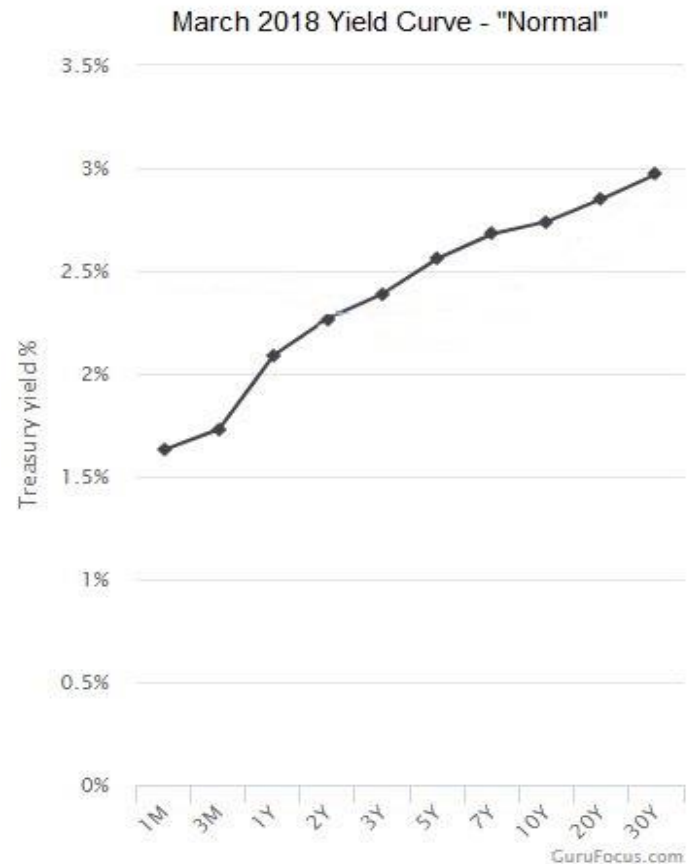
- No fixed yield or maturity date – less certainty of outcome
- Less control of investments
- FEES: (0.2% to 1.5%)

Buying Bond Mutual Funds

- Using bond mutual funds is the better choice for most investors
- Understand maturity/term and sectors owned
- Current yield and recent performance are not good indicators of future performance
- Watch fees! Lower fee funds outperform higher fee funds

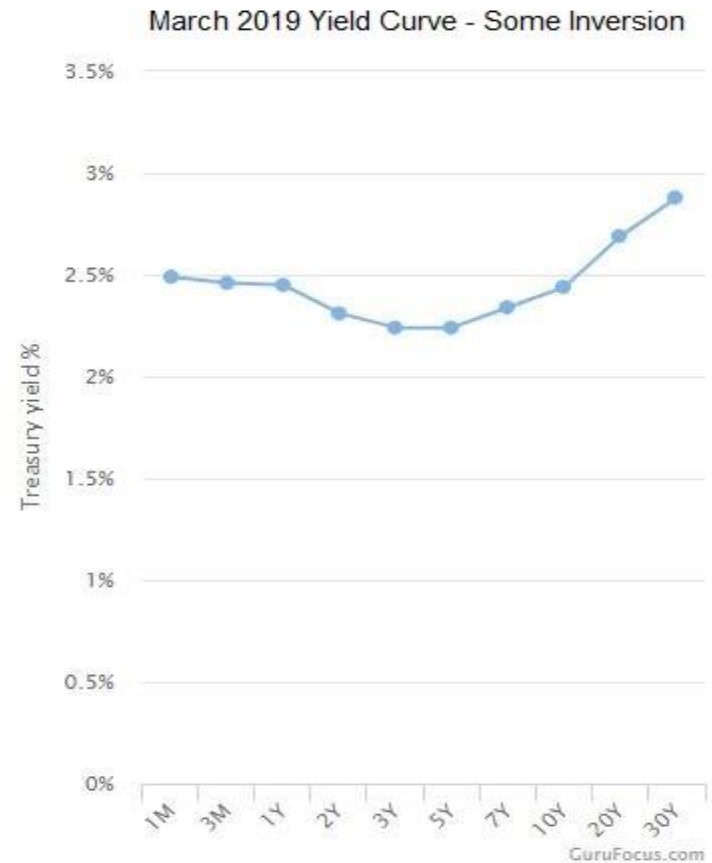
Yield Curves – Normal Yield Curve

- In most environments, short-term bond yields are lower than long-term bond yields
- This makes sense since longer-term bonds carry more risk for which investors need to be compensated



Yield Curves – Inverted Curve

- There are times when short-term bonds actually yield more than long-term bonds – this is called a yield curve inversion
- These times are interesting because they show that the bond markets are pessimistic about the future of the economy
- “Inversions” have been a good predictor of future recessions



When Recessions Happen

- Performance of the stock market before, in and after recessions aren't *too scary*

	1 Year Prior	Recession	+1 Year	+3 Years	+5 Years
Aug 1957 - Apr 1958	0.8%	-6.4%	37.2%	66.1%	89.3%
Apr 1960 - Feb 1961	3.1%	18.3%	13.5%	34.8%	67.7%
Dec 1969 - Nov 1970	-10.7%	-3.4%	11.3%	20.4%	24.8%
Nov 1973 - Mar 1975	-0.1%	-18.2%	28.3%	21.6%	54.8%
Jan 1980 - July 1980	18.5%	16.4%	13.0%	56.0%	100.0%
July 1981 - Nov 1982	20.7%	14.4%	25.5%	66.4%	102.4%
July 1990 - Mar 1991	16.5%	7.6%	11.1%	29.9%	98.3%
Mar 2001-Nov 2001	-8.2%	-7.2%	-16.5%	8.4%	34.2%
Dec 2007-June 2009	7.7%	-35.5%	14.4%	57.7%	136.9%
Averages	5.4%	-1.5%	15.3%	40.1%	78.7%

Source: awealthofcommonsense.com