Advisors stepping up to bond ladders as Fed pushes rates up another quarter point

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By Jeff Benjamin InvestmentNews

Spreading fixed-income exposure over several years of maturities provides predictable income in an unpredictable economic environment.

There's nothing quite like rising interest rates, inflation, and an inverted yield curve when it comes to testing the mettle of investors allocated to the classic bond-laddering strategy.

"Even though the short-term rates are so high at this point, making it look almost unnecessary to build bond ladders, implementing strategies around bond maturities still helps investors hedge interest risk and diversify performances," said Kristy Jiayi Xu, chief executive of Global Wealth Harbor.

In bond laddering, buying bonds that mature at regular intervals over a five-, 10- or 20-year period is designed as a stress-free way to reduce interest-rate risk. Proponents of laddering say that while the total portfolio might generate a below-market return in a rising rate environment, the maturing bonds can be reinvested at higher rates.

After the Federal Reserve's eight straight interest rate hikes over the course of a year, and with inflation starting to slowly cool down, the smart money sees rate cuts on the horizon, which could create some tough conversations for advisors with clients in laddered bonds.

"The majority of economists expect the Fed to begin cutting interest rates in 2024, so investors who invest only in short-term bonds today will have to invest in lower-yield bonds when their short-term bond comes due," Xu said. "To avoid that, investors may

still want to purchase intermediate or long-term bonds to lock in the current rate. Also, while the short-term bonds provide the price stability with its liquidity, bonds with longer maturities are more sensitive to rate changes than those with shorter maturities, and so when the interest rate falls, the long-term bond will see a larger price increase."

The current nuance around interest rates is not lost on Craig Toberman, founder of Toberman Wealth.

"Now is a good time to be locking in rates that are short- to intermediate-term with a bond ladder going out four, five or six years," he said. "A year ago, when rates were still low, it didn't make sense to build a bond ladder that went out more than a year, but we had a unique situation when rates were near zero and I couldn't recommend a bond ladder."

Toberman said that if he were building a bond ladder from scratch today, he would buy individual Treasury bonds with maturities from one to five years.

"If I can get 3.6% to 3.8% on a five-year Treasury, then I'm happy to lock that in right now, and I'll have it locked in if rates fall," he said. "But if rates are below 1%, then I'm not doing a bond ladder."

The inverted yield curve, with yields on shorter-term bonds higher than yields on longer-term bonds, doesn't change the laddering strategy for Leyder Murillo, managing director at Wolfpack Wealth Management.

"Building a bond ladder can still make sense in an inverted yield curve environment, although in an inverted yield curve scenario, the ladder would be focused more on the short end because short-term bonds and bank CDs tend to have higher yields compared to longer-term bonds," Murillo said. "Although there may be some cautionary winds on the horizon, as doing this type of short-term strategy may have peaked this year. The market is starting to price in rate cuts toward the end of the year. It may make more sense to add duration to a client portfolio and start to focus on the tail end of the curve rather than the front end."

Just as interest rates near zero make bond ladders a tough sell to some clients, the suddenly higher yields on bank savings accounts and money market funds can make bond ladders look weak by comparison.

Karen Ogden, partner at Envest Asset Management, said it's a mistake to compare some higher-yielding savings accounts to a bond laddering strategy.

"We think it does still make sense to build bond ladders even if the real return is flat to a big negative," Ogden said. "This is mostly true for older investors who may be closer to retirement and need some certainty around investment performance. It is always true that individual circumstances matter, and a bond ladder may be less appropriate for younger investors. However, as inflation does moderate and the Fed stops hiking rates,

we expect to see nominal rates come off their current higher levels and real returns to increase."

Amy Hubble, principal investment advisor at Radix Financial, believes now is among the best times to build a bond ladder, "perhaps more than any time in the last decade."

"Buying individual bonds along a ladder allows us to lock in the rate of return we're going to earn on the day of purchase, dutifully collecting coupon payments, and holding to maturity," she said. "Building a 10-year ladder means that one-tenth of your bonds will mature every year, giving you liquidity if needed for spending, or otherwise reinvestment for another 10 years out. No retail fund flows or further Fed action will affect your return if you hold each to maturity, which greatly minimizes risk to the overall portfolio while still rewarding clients with low-risk, regular cash payments."

And for clients nearing retirement, Hubble said "rising rates is a best-case scenario."

"If we can all but guarantee that your day-to-day living expenses during retirement can be covered by the interest generated from an increased bond allocation, it makes the volatility of the equity portion of the portfolio much easier to sustain over short periods of time," she said. "We view this as a healthy dynamic and welcome the return to a normalized interest-rate environment."