FIXED INCOME

Worried About an Inverted Yield Curve? Diversify Your Income Sources

By ROBERT POWELL + Follow | APR 21, 2018 | 12:00 PM EDT

Some fixed-income experts are starting to fret about an inverted yield curve.

But that's not necessarily something Steven Mula, the chief investment officer of JJ Burns & Co. is worrying about at the moment.

"The advice we have for fixed-income investors is broadly similar to what we tell equity investors: diversify your income sources, and understand the risks in your portfolio," he says.

On the first point, he says bonds -- like equities -- have a variety of characteristics.

The approximate risk spectrum is cash (deposits and money-market securities), U.S. Treasuries, governments (agencies), investment-grade corporates and mortgages, munis, asset-backed bonds, preferreds, bank loans and high-yield bonds, foreign issues (developed and emerging), and private placements.

"That's 13 sectors, each of which is different from the others," he says. "Note that munis have risks similar to other spread products, including interest-rate risk, credit risk, liquidity and policy risk. Equities have a structure based on market cap, style, region, and the like."

So, if investors get too cautious and hold too much in the first three to five categories, they court low yields and higher reinvestment and interest-rate risk. Too much in the latter four counting foreign as two sectors), and they take on too much credit and sovereign risk. "Clearly, balance is important," says Mula.

If the Fed's policy rate declines, it may not be lowered more than 25 basis points, he says. "A more likely scenario is the Fed pausing in their hike regime to give markets and investors a breather," says Mula. "That would be welcome. However, the Fed is clear: Rates have to go higher, and they're committed to raising them. Right now, they're normalizing, not tightening."

Remember, he says, that the Fed controls only short-term rates; the market determines the important 10-year and longer rates in the market.

"Finally, overhanging any Fed decision is the projected U.S. deficits, which threaten to balloon Treasury issuance if a recession occurs or if auctions get substantially larger," says Mula.

Given that, here's what Mula says investors might consider:

Keep a cash reserve to cover living expenses in case of a correction. Start with two years of reserves, but whatever investors are comfortable with is the right number. As short-term deposit and cash yields have risen and the spread with longer-term bonds has narrowed, this means short-term money now earns a decent yield in the market and is no longer a "dead" asset.

Have a good, diversified core portfolio of quality bonds (muni or taxable). This may be a laddered portfolio or a good, low-cost mutual fund or ETF. This will ideally offer an equity-correction haven and keep higher-quality credits in the portfolio.

Add some "income alpha" to the portfolio. At this point in the cycle, some high-yield and quality bank-loan exposure may provide some additional income over traditional bonds without the interest-rate risk longer maturity bonds take.

More adventurous investors may add emerging-markets bonds, preferreds (in a fund structure) and real-asset plays for income from sources that aren't strictly interest- rate reliant for returns. These exposures should be in smaller increments to avoid too much possible capital loss.

Mula says he has looked at income-producing closed-end funds (CEFs), and some have attractive yields. However, he says, their leverage ratios and premium/discount history should be analyzed before purchasing. Yields may be attractive, he says, but some issues may have liquidity concerns, as CEFs are traded like equities and may trade at steep discounts to NAV at times during the market cycle.

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