

Why Are So Many Investors Being Subjected to Yield Risk?

As short-term interest rates have risen dramatically, even to the point where the yield curve is inverted, investors have poured assets into money market funds and other cash instruments. That leaves investors vulnerable to a decline in short-term rates. So, what is the right strategy for your clients?

What benefit are your clients gaining in cash that makes it acceptable to subject them to significant reinvestment risk? Is immediate liquidity really necessary? If not, that means you or your client is forecasting short-term rates will not decline significantly. But predicting near-term changes in interest rates is notoriously difficult and often the outcome is much different than expected.

Maybe opting for cash is due to fear that longer-term rates will increase further, driving down the value of bond holdings. In that case, consider portfolio duration in the middle. Maybe a 5-year note or a laddered portfolio with a 5-year duration makes sense.

But as you survey the yield curve and the fixed-income strategies you have available, the most important factor to weigh is your client's investment objective and time horizon. Align client spending time horizons with portfolio maturity schedules. Short-term spending needs should be funded with short-term maturity instruments and vice versa.

You may be surprised to find on the pages that follow that locking in a lower rate for a few years compared to remaining in money market funds can pay off without a dramatic drop in short-term rates.

Case Study: Bond Duration is Less than Investment Horizon

Bond Duration	5 Years
Investment Horizon	20 Years
Starting Interest Rates*	1%
Starting Wealth	100,000

Scenario 1

Starting rates remain at 1% throughout the entire period

Scenario 2

Interest rates immediately increase to 4% and remain at 4% throughout the period

Growth of Wealth

	Scenario 1	Scenario 2
0	\$100,000	\$86,385
1	\$101,000	\$89,841
2	\$102,010	\$93,434
3	\$103,030	\$97,172
4	\$104,060	\$101,059
5	\$105,101	\$105,101
6	\$106,152	\$109,305
7	\$107,214	\$113,677
8	\$108,286	\$118,224
9	\$109,369	\$122,953
10	\$110,462	\$127,871
11	\$111,567	\$132,986
12	\$112,683	\$138,306
13	\$113,809	\$143,833
14	\$114,947	\$149,592
15	\$116,097	\$155,575
16	\$117,258	\$161,798
17	\$118,430	\$168,270
18	\$119,615	\$175,001
19	\$120,811	\$182,001
20	\$122,019	\$189,281

Longer-term bonds are more prone to total return losses from rising interest rates. But those losses can be at least partially made up over time through reinvestment of income at higher rates given a long enough time horizon.

As these exhibits from Dimensional Funds illustrate, an investor who had the unfortunate timing of investing in a 5-year bond yielding 1% (the prevailing rate prior to the 2022 Fed rate hikes) and then saw rates rise to 4%, could have made up the initial losses by the 5th year and outgain the original bond if rates had stayed at 1%¹.

The key for managing fixed-income risk is to ensure that the investment time horizons of your client are aligned with the maturity profiles of the fixed-income portfolio.

* Assumes flat yield curve.

For illustrative purposes only. Case study is provided for informational purposes only. Data presented in the Growth of Wealth chart are hypothetical and based on mathematical principles, are not representative of indices, actual investments or actual strategies managed by Dimensional, and do not reflect costs and fees associated with an actual investment. Fixed-income securities 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.

¹ "Bond Talk: Current Topics in Fixed-income," Dimensional Funds Advanced Conference September 2022

			Growth of \$100,000		
Term	3 Month Implied Forward Rates (SOFR)	5-Year Treasury Bond Yield	Term	Money Market Proxy	5-Year Treasury Bond
1M	4.95	3.76	1M	\$100,403	\$100,308
2M	5.28	3.76	2M	\$100,808	\$100,616
3M	5.17	3.76	3M	\$101,242	\$100,926
4M	5.01	3.76	4M	\$101,668	\$101,237
5M	5.01	3.76	5M	\$102,083	\$101,548
6M	4.85	3.76	6M	\$102,499	\$101,861
7M	4.61	3.76	7M	\$102,904	\$102,174
8M	4.61	3.76	8M	\$103,291	\$102,489
9M	4.38	3.76	9M	\$103,680	\$102,804
10M	4.14	3.76	10M	\$104,051	\$103,120
11M	4.14	3.76	11M	\$104,404	\$103,438
12M	3.91	3.76	12M	\$104,758	\$103,756
2 Years	3.47	3.76	2 Years	\$108,395	\$107,653
3 Years	3.04	3.76	3 Years	\$111,691	\$111,697
4 Years	3.08	3.76	4 Years	\$115,133	\$115,896
5 Years	3.11	3.76	5 Years	\$118,708	\$120,249

The 3-month Secured Overnight Financing Rate (SOFR) can be viewed as a proxy for current and expected money market fund rates. This table illustrates the impact on income generation from declining yields (resulting from an inverted curve) as priced in by the SOFR curve versus the income generated from a fixed 5-year maturity Treasury Bond or a 5-year A-Rated Corporate Bond².

			Growth of \$100,000		
Term	3 Month Implied Forward Rates (SOFR)	5-Year A-Rated Corporate Bond	Term	Money Market Proxy	5-Year A-Rated Corporate Bond
1M	4.95	4.72	1M	\$100,403	\$100,385
2M	5.28	4.72	2M	\$100,808	\$100,771
3M	5.17	4.72	3M	\$101,242	\$101,159
4M	5.01	4.72	4M	\$101,668	\$101,549
5M	5.01	4.72	5M	\$102,083	\$101,940
6M	4.85	4.72	6M	\$102,499	\$102,332
7M	4.61	4.72	7M	\$102,904	\$102,726
8M	4.61	4.72	8M	\$103,291	\$103,122
9M	4.38	4.72	9M	\$103,680	\$103,519
10M	4.14	4.72	10M	\$104,051	\$103,917
11M	4.14	4.72	11M	\$104,404	\$104,317
12M	3.91	4.72	12M	\$104,758	\$104,719
2 Years	3.47	4.72	2 Years	\$108,395	\$109,661
3 Years	3.04	4.72	3 Years	\$111,691	\$114,836
4 Years	3.08	4.72	4 Years	\$115,133	\$120,255
5 Years	3.11	4.72	5 Years	\$118,708	\$125,929

The initial income from the money market fund proxy is higher in the initial year but then lags the 5-year bond as rates are expected to be lower in the outer years.

² Source: Bloomberg. Data as of 5/31/2023. For illustrative purposes only. This analysis assumes 3-month annualized rates are realized as projected by SOFR interpolated pricing as of 5/31/2023 and a flat yield curve for the reinvestment of the 5-year Treasury Bond and A-Rated Corporate Bond (no default) held to maturity.

Conclusions

- Short-term fixed-income has greater reinvestment risk.
- Longer-term fixed-income allows investors to lock in rates.
- Aligning investor time horizons with portfolio maturities helps address both reinvestment risk and total return risk resulting from interest rate volatility.

Guidance

[Read our recent guidance](#) regarding how to restructure fixed-income portfolio duration.

Freedom Advisors has a diversified lineup of fixed-income strategies including strategies that take on the management of duration and diversification, as well as specific duration and sector strategies. The portfolio models below are a few suggestions available today in Freedom Advisors:

Managed Duration:

- [EQIS 5yr Corp Bond Ladder ETF Strategy](#)
- [EQIS 7yr Muni Ladder](#)

Managed Income:

- [PIMCO Income Fund](#)
- [SignalPoint Stable Income](#)

Flexible Fixed-income:

- [Financial Trust Flexible Income](#)
- [SignalPoint Stable Income](#)

ESG Fixed-income:

- [Calvert ESG Bond Fund](#)
- [EQIS ESG High Yield Debt ETF](#)

Short Duration:

- [EQIS Short Term credit ETF](#)
- [Calvert ESG Short Duration Income Fund](#)

If you would like to speak about the fixed-income investments in your portfolio, please contact:

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Schedule a Meeting



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