



## Three Bond Funds for Rising or Falling Rates

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Several actively managed bond funds have achieved significant outperformance relative to their benchmarks despite recent low interest rates. The strategies employed by these funds can and will continue to outperform without needing rates to fall further.

Many investors today wonder if near-zero interest rates make investing in bonds unwise. A number of prominent investors have been vocal about deciding to be short U.S. Treasury bonds over the last few years. These bond bears were quick to point out that the asset class has been in a 30-year bull market and that absolute rates have little room to fall.

Since the 10-year Treasury's record-low yield of 1.38% in late July, its yields have spiked sharply. The 10-year Treasury yield rose almost 50 basis points in less than a month's time before falling back to the mid-1.60s as of August 24.

My objective is not to dwell on short-term market fluctuations but to highlight the typical fears that reluctant bond investors face. It is not practical to time or predict interest rate movements, but it's helpful for investors to understand that the success of various fixed-income strategies isn't necessarily predicated on continued falling rates.

Let's look at how three funds are positioning to outperform despite the current environment.

### **PIMCO's "best ideas" fund**

PIMCO's Dynamic Income Fund (NYSE: PDI) is a relatively new closed-end fund, having had its IPO on May 24 of this year. It invests in a multitude of fixed-income asset classes. As of August 24, the fund's net asset value (NAV) had increased 11.08% since its inception. The bulk of its outperformance has come from the non-agency mortgage-backed security (MBS) portion of the portfolio, where prices have risen between 5% and 10% over the past few months.

PDI's holdings in the debt of financial corporations (Cantor Fitzgerald, Morgan Stanley, Lazard, and Société Générale, among others) have rallied strongly in lockstep with equities. The fund also has exposure to high-yield debt and levered loans of such companies as INEOS Finance PLC and First Data Corporation.



Because levered loans typically float to LIBOR, those securities have minimal interest rate risk – just spread and credit risk. PDI is also throwing off a lot of income with a 17.7-cent monthly dividend, or about 0.65% a month.

Although this fund may be less sensitive to interest rates than a vanilla, U.S. Treasury-heavy bond fund, it is not risk free. It faces substantial credit and spread risk. Also, unlike an open-ended mutual fund that trades at net asset value (NAV), closed-end funds can trade at a premium or a discount to their NAV.

### **DoubleLine's approach**

Jeffrey Gundlach's DoubleLine Total Return Bond Fund (DBLTX) attracted the most money of any mutual fund through June of this year, according to Morningstar – about \$11.5 billion. It's no wonder it has been so popular; as of August 15, the fund had a total return of 35.95% since its April 2010 inception. The fund has returned an annual equivalent of 13.89%, while its benchmark – the Barclays Capital Aggregate Bond Index (AGG) – returned 6.75% during the same period.

The fund has also performed well this year, with a total return of about 6.97% year-to-date. Since the 10-year Treasury's hit that record record low in July, DBLTX has gone up in price. I would categorize Gundlach's Total Return Fund as much less "directional" than other funds, which is to say that Gundlach pursues a contrarian strategy. While other funds loaded up on longer pass-throughs ([high LTV, low loan balance](#)), which trade at premiums to normal MBS pools, Gundlach was busy buying out-of-favor pools backed by higher-balance loans, which trade at a discount.

Although such a strategy may lag peers if interest rates stay low, his portfolio is set up to make money across a wide range of interest rate scenarios. Non-agency MBS and cash holdings provide a buffer if rates move higher, because they are considered to have negative [duration](#). Non-agency bonds will increase in value as the economy improves and rates rise. The bottom line is that this portfolio is not betting on rates to move in any one direction, and Gundlach has demonstrated great skill at combining various assets that outperform as a portfolio.

### **A new entrant**

A lesser-known fund is the Performance Trust Total Return Bond Fund (PTIAX). This fund has a total return of 10.08% year-to-date, which puts it in the 97th percentile in its asset class, according to Bloomberg. Since its inception on August 31, 2010, PTIAX has returned an annual equivalent of 10.88%, which compares nicely with the 4.75% return for the Barclays Capital Aggregate Bond Index during the same period.



One of the fund's major benefits is that it is exceptionally nimble. With assets of only about \$40 million, the fund can be a lot more selective in its choice of bonds than the DoubleLine or PIMCO funds, which both deal with many times more assets. Like PDI and DBLTX, PTIAX has substantial holdings in the non-agency MBS sector.

Because smaller allotments of bonds, or "odd lots," usually come with a price break, PTIAX is able, in a sense, to buy bonds more cheaply than its larger competitors. In addition to non-agency MBS, the other portion of PTIAX's "barbell" is longer-duration, tax-exempt municipal bonds. In the event that interest rates continue to rise, the municipal portion of PTIAX should provide a relative volatility buffer.

Tax-exempt municipal bonds typically sell based on their tax-equivalent yield; thus, such bonds have roughly two-thirds the price volatility of taxable bonds. In other words, thanks to the tax benefit, a 100-basis-point increase in the tax-equivalent yield would increase the tax-free yield by only about 66 basis points. Furthermore, municipal bonds still trade at historically wide spreads to U.S. Treasury bonds, and they trade at higher yields. If U.S. Treasury yields do rise, spreads could revert to the historical average, which could further mitigate price depreciation. As previously stated, investors would be taking on credit and spread risk by purchasing a fund like PTIAX.

### **Don't write off bonds**

It is certainly possible to own bond funds and enjoy positive returns without relying on Treasury yields falling to ever-lower lows. Many of the funds that are most protected from a rise in Treasury yields require investors to take on credit and spread risk instead of interest-rate risk alone. Actively managed bond funds, such as PDI, DBLTX, and PTIAX, have illustrated this fact, with outperformance in periods of both falling and rising rates.

Bond funds today, then, aren't all dead-end streets – you just need a roadmap to see who has found a way through.



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