



There's No Such Thing As Free Yield

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Steve Laipply: I think in fixed income in particular right now, investors are really struggling to understand how to generate yield, and, in fact, what the cost of generating that yield is. So the one thing upfront is that you don't get yield for free. So each time you are trying to generate enhanced income and earn more yield, you are taking on some kind of risk. And I think the most important thing is that investors understand what risks they're actually taking in order to get that extra yield.

So right now, money markets are yielding practically nothing. Deposits are yielding practically nothing. The Fed's made it clear that that's intentional. So investors are searching for fixed income alternatives that allow them to get more yield, but they also want to understand what risks they're taking.

And so the way we like to think about this is that in fixed income you have three basis risks that you can take. The first one is interest rate risk. So what that really means is for longer maturity bonds, you have much more exposure to rising or falling rates than you do for very short-maturity bonds such as treasury bills. As an example, 30-year treasuries are extremely sensitive to changes in interest rates as compared with three-month treasury bills.

So an investor who wants to earn more yield will do so by holding 30-year treasuries, but the cost of that is the risk that interest rates could rise. In the case of holding a 30-year treasury bond as opposed to a three-month treasury bill, you will have a lot more price volatility with that.

In another dimension, credit risk is another way to enhance your yield. So one way to earn extra yield is by holding riskier securities from a credit standpoint. What does that mean? That means treasuries are risk-free. Some people would take issue with that based on now what the fiscal picture looks like. But you can compare that with something like a high-yield investment where you're taking on a lot of credit risk.

Speculative grade or high-yield companies are typically much lower-rated, which means that there is a greater likelihood that they could default. So you are getting paid quite a bit more yield for holding a speculative grade or high-yield bond, but the risk of that is that that company could default and you would not get your principal back.

And then the last thing is a more general term, which we'll call volatility risk. But a specific example of this would be a homeowner's right to prepay on a mortgage. So relative to, say, treasuries of similar maturity, you will get paid more yield to hold a mortgage-backed



security. The reason you are getting paid more yield is because if interest rates fall, homeowners are likely to refinance, and that bond will get called away from you.

And if you think about what that means, you bought that bond at a certain yield, you'd like to hold onto it, but if rates fall, that bond gets taken away from you, and now you're forced to reinvest your money at a lower yield. And so that's what we like to refer to as volatility risk or call risk.

Now, what's really interesting about these risk dimensions is that bonds usually fall somewhere in a continuum in between them. So for interest rate risk, you could argue that treasuries are almost entirely interest rate risk. So we could put treasuries up here. And long-duration treasuries, as we said, have the greatest degree of interest rate risk. We already discussed high-yield for having the most credit risk. And then finally, we'll say that mortgages are an example of a bond that has more volatility or call risk.

Now, in reality, all of these securities can lie somewhere on a continuum here. So, for example, investment-grade corporate bonds have aspects of all these things, or can. So investment-grade corporate bonds are credit-risky. They're riskier than treasuries, but not quite as risky as high-yield. So they can fall somewhere in between here.

If it is a callable investment-grade corporate bond, it can actually shift further over, because it now has call risk. If it is a callable investment-grade corporate bond, it can move more towards this dimension -- "callable" meaning much like a mortgage-backed security. If interest rates fall, the corporation that issued that bond may decide to call it and then reissue a bond at a lower rate.

So municipals are another example of bonds that can have aspects of interest rate risk, call risk, and credit risk. So municipals would also fall somewhere in the middle of this spectrum.

So, as an example, you could have higher-rated municipal issuers who issue callable bonds. That could be up here, away from the credit risk spectrum. Or you could have much lower-rated municipal issuers that issue callable bonds. That could be somewhere down here. So the point is, is to really understand where your investment in fixed income falls along these lines.

And the most important point is, is that yield never comes free. You are taking some of these risks, some combination of these risks, in order to get paid that extra yield. And for investors, the most important thing is to really have a clear view on what risks they're taking and be comfortable with that in the context of the yield that they're earning.

Steve Laipply: So a fixed-income investor who's trying to decide how to allocate among these risks has to have a view of what risks they're comfortable with. So an investor who isn't terribly concerned about interest rates rising over the near-term, or perhaps even the



long-term, would potentially hold or be comfortable holding longer maturity treasuries.

An investor who may be worried about interest rate risk but is comfortable with credit risk -- for example, if they have a view that the economy is not likely to stumble of the coming months or years -- may be comfortable holding something like high-yield in order to earn that extra yield.

And then lastly, an investor who believes that the environment is going to be relatively stable -- so not only are rates not necessarily going to rise, but they may not necessarily fall either, and so they may be range-bound -- would likely hold something like a mortgage-backed security, because they believe that they can earn that extra yield without the risk of that bond being called away from them.

Now lastly, investors who have some concerns about each of these risks may ultimately end up holding something like investment-grade credit or higher-grade municipals. Again, as we discussed, these bonds may have some callability to them, depending on the issuer or the structure. But investors who have some view in all these risks, but, you know, aren't terribly concerned about any of them may be in that sort of center area where they hold investment-grade or high-grade municipals.

The most important point, though, is really understanding the fact that you can't earn higher yield without taking some risk. And so for investors, they need to understand between interest rate risk, credit risk, and volatility or call risk what they're comfortable with and how they want to earn that extra yield.

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