

How to use bond ladders to address both inflation & deflation

By **John Radtke** August 9, 2010

A recent survey of financial professionals on fixed income allocations indicated a continuing strong preference for municipal and corporate bonds.

Among the seven asset classes listed, municipal bonds ranked first in terms of ‘most likely to increase’ allocations during the next six months. Over 65% of advisers responded that they expected to increase allocations to municipal bonds in the near term. Investment-grade corporate bonds ranked second, with 62% of advisers expecting to increase the percentage allocated to high grade corporates.

Why are so many advisers and investors choosing municipal and corporate bonds in the current interest rate environment? The conventional answers might include yield enhancement relative to US Treasuries, reliable income and a high degree of principal security.

A less often cited reason for fixed income securities is that laddered bond portfolios can address both inflation and deflation concerns.

Deflationary pressures are on the minds of many fixed income professionals, including PIMCO’s Bill Gross who observes that the U.S. may be ‘tipping toward deflation’. Mr. Gross said recently that ‘deflation isn’t just a topic of intellectual curiosity, it’s happening’, citing an annualized 0.1% decline over the past two years in the U.S. consumer-price index.²

While an extended period of deflation may not be the most likely economic scenario, notable economists such as St. Louis Fed President James Bullard have warned of a Japan-like period of deflation and slow growth. In a slow growth and mild deflation environment, intermediate- and longer-dated municipal and corporate bonds typically perform well. If inflation pressures return, short-dated bonds will roll off to enable reinvestment at higher rates.

When faced with the question of ‘how best to own bonds?’, investment professionals often decide to build custom bond portfolios instead of paying fund or ETF management fees. The recent survey indicated that about 40% of advisers typically favor individual bonds for fixed income allocations, while 44% favor bond funds and 16% favor bond ETFs.³

Municipal and corporate bond funds and ETFs have several potential advantages: instant diversification, tradability, and professional management. Bond funds and ETFs are proven instruments that can add value, particularly for smaller portfolios.

However, if a fixed income portfolio is over \$250,000, a custom portfolio of bonds could be a good choice. And if the portfolio has at least 10-15 issues of highly-rated bonds, it may be sufficiently diversified.

An interesting option for laddering bonds is a ‘hybrid barbell’ approach, which is essentially two ladders. A ‘liquidity generator’ in the short end could be comprised of a 1-5 year ladder with sequential 6 month final maturities. This short ladder is designed to create fresh principal in a perceived ‘rich’ short term market, with an expectation for reinvestment at higher rates in an inflationary environment. The second ladder could be an income or ‘yield generator’ which focuses on 10-20 year maturities where higher yields are available. Taken together, this hybrid ladder addresses liquidity needs while still benefiting from the relative value further out the yield curve.

Naturally, there is credit risk to be considered, and sufficient time must be allotted to determine the creditworthiness of each holding. The probability of default among the vast majority of municipal bonds is very low. However, the default risk may rise in localities with high jobless rates, foreclosures, lower home values and slowing retail sales – all of which constrict state and local tax revenues.

Likewise, while the default risk of investment grade corporate bonds is historically low, it is not insignificant. Bond funds and ETFs are diversified to address this risk, and well-managed portfolios of individual bonds can achieve the same objective.

Custom-built laddered portfolios of new issue and secondary municipal and corporate bonds have numerous advantages. These include defined maturity and interest payment schedules, control over exactly which bonds are held, and tax efficiency.

New issue bonds can further simplify the process of owning individual securities, with clear pricing and tax consequences. Online resources for building custom bond portfolios include FINRA’s investinginbonds.com and [Incapital’s incapital.com](http://incapital.com).

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1Survey Source: Incapital July 2010 online survey of 722 Investment Professionals

2Full context of the Bill Gross quote from wsj.com on August 1, 2010:

<http://online.wsj.com/article/SB10001424052748703787904575403204077239996.html?KEYWORDS=bill+gross>

3Incapital survey results from July 2010 are available on request from info@incapital.com.