Top Strategies For Fixed Income

The scramble for yield pushes planners to get creative

By Ann Marsh

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Advisors everywhere know the story all too well: A client worked and saved his entire life and put everything - or nearly everything - into fixed-income securities to prepare for retirement. In doing so, he expected to live out the rest of his life comfortably on returns of 4% to 5%, never touching the principal. Then the world changes: Treasury yields drop to historic lows of less than 2% or even 1%, with some even generating negative returns after factoring in modest inflation, forcing planners and investors to rethink everything.

"What I hear a lot is, 'It's time to refocus on me,' " says Douglas Ciocca, CEO of Kavar Capital Partners in Leawood, Kan. "It was great to have this goal of making all my kids millionaires or funding my charity, but now I need to take care of myself." This may mean spending less in retirement, donating less to charity, gifting less - if anything - to heirs. And it means finding new and reliable streams of income to save, or repair, plans for the future.

To root out the top strategies for fixed income for this month's cover story, Financial Planning spoke with advisors and financial professionals around the country about their varying game plans. Broadly speaking, most include diversification, hedging and retrenching. Many of the solutions go beyond the technical definition of the term "fixed income" to include equities, insurance and trusts that generate income streams.

Above all, creativity is the watchword for forging new fixed-income solutions. "My response to [worried] clients is to embrace this new environment and adapt to it," says Brian Kazanchy, a wealth manager and chairman of the investment committee at RegentAtlantic Capital in Morristown, N.J. "The solutions that were great for the past 10 years ... are probably not the solutions that will serve us best over the next 10 years."

Instead, Kazanchy, Ciocca and other planners are steering away from Treasuries and municipal bonds, moving toward a cornucopia of bonds with higher risks and, they hope, higher rewards. These might include corporate bonds and high-yield bonds, as well as fixed-coupon premium bonds, floating-rate bonds and fixed-to-float bonds.

But, in most cases, planners are letting outside managers do the heavy lifting. Some have made real estate a top priority by investing in the much-maligned world of mortgage-backed securities. Others lobby their clients to diversify out of the markets and buy homes and commercial properties when that makes sense.

For high-net-worth clients who fit the right profile, some planners create income streams through the use of charitable trusts or annuities. Under some circumstances, others are opting to pay high prices for insurance company annuities. In almost every case, planners told FP they were urging clients to put at least some portion of their fixed-income portfolio into equities.

But it's not an easy sell. Kazanchy shares the story of a single client in her late 60s who is eager to retire. Recently, when she went to the bank to renew a CD, she was offered a return of 0.7%, a steep

drop from the 4% to 5% the bank was paying a while ago. "Her frustration," Kazanchy explains, "stems from leading a responsible life, working long hours, paying the mortgage on time, forgoing vacations and other purchases in favor of building a nest egg to retire on."

Now, the Federal Reserve's priority is to keep rates low to nurse the housing market and broader economy back to health - at the expense of savers like her. Her two choices, as Kazanchy sees them, are either to pull back on the retirement lifestyle she had worked hard to ensure or to expose some of her portfolio to risk in the hopes of generating growth.

"However, if the risk tolerance is not commensurate with the strategy, [she] will be more likely to do permanent damage to [her] financial well-being by selling out after the market declines," he says. "For investors seeking low volatility and a stable return, the trade-offs can be severe." The following strategies may help mitigate or possibly eliminate the sting of continued market volatility.

BOND OPTIONS

There are four bond categories that planners should consider exploring for their retirement-minded clients:

* **Mortgage-backed securities**. The economic crisis of 2008 exposed a vast global over-evaluation of mortgage-backed securities. Lost in the subsequent stampede to sell were securities that did - and still do - possess strong underlying fundamentals.

"There's a great deal of value there because most investors said, 'I don't want any part of it' " says Hank McLarty, founder of Gratus Capital Management in Atlanta and a former fixed-income trader at Morgan Stanley. "The yields are quite good" - 15% or 16% - "if you have the ability to go find them," he says.

With an expert eye, it's possible to evaluate the quality of the loans in a given loan pool, McLarty maintains. Bloomberg publishes data on the types of borrowers and loan details. Some pools include residential home loans ranging from $600,000 to $800,000 with 20% deposits and borrower incomes between $300,000 and $400,000, he says. These are the loan pools that Gratus is seeking out and investing in. But McLarty warns, "It's like an X-ray. If you don't know what you are looking at, you don't know what you are looking at."

Among planners who don't want to take the time to scrutinize individual securities, many are choosing to invest with asset managers who specialize in this class. Other planners urge their clients to buy homes and commercial real estate themselves. Clients who are business owners, according to one planner, should consider buying the properties where they rent space. In the process, they diversify their holdings away from an overbalanced investment in the business itself, not to mention the volatile stock market.

* **Opportunistic bonds**. In his practice, Kazanchy's firm has allocated fully 45% of its fixed-income investment to so-called opportunistic bond managers. These are managers who run mutual funds that give them broad permission - if not total freedom - to invest anywhere in the bond market that they see opportunities. "You are giving them the latitude to go anywhere in the bond market, not just to Treasuries, corporate bonds or munis," Kazanchy says. "They can also short-sell."

A security's maturity date is an important factor, he adds. "We like having these opportunistic managers where they are keeping things very short. Today, I'm not getting paid well at all for locking up my money." Keeping investments short term lowers interest rate risk.

At the same time, he says, these managers are taking on higher credit risk by investing in lower-grade bonds with potentially higher returns. Still, "the double-D and the single-D areas of rated companies are paying good interest rates," Kazanchy says, "and not many of those companies are going out of business because profits have recovered and balances are strong. It's a good time."

However, Eric Toya, a planner at Trovena Capital in Redondo Beach, Calif., says opportunistic bond strategies can prove risky. "We had some bad experiences with that," Toya says. "The correlation with the stock market ended up being much higher than we anticipated in the down market."

* **Sovereign debt denominated in foreign currencies.** Yes, emerging markets underperformed in the latter part of 2011. But many planners expect them to fare better this year. "Emerging markets are relatively healthy compared with the rest of the world," says Richard Burridge Jr., CEO and chief investment officer of RMB Capital Management in Chicago.

Like other planners, Burridge expects rates to rise on debt denominated in foreign currencies. That's not the only attraction; there's also the hedge of holding assets in another currency.

"The currency benefits should be positive as emerging market currencies appreciate compared with the dollar," he says. "If you look at the long-term chart of the U.S. dollar, it's been depreciating over time. While we primarily have a U.S. bias, we like to introduce some currencies into the allocations in order to maintain a client's global purchasing power."

Still, this is not a boring sector. Burridge cites one major emerging market bond fund that delivered the following returns: 29% in gains in 2008, a drop of 11% in 2009, a bounce of 13% in 2010 and a drop of 2% last year. "We don't like the volatility," he says, "but since we have very long time horizons, we use the volatility to rebalance our allocations."

Ralph Divino, a fixed-income client portfolio manager at ING Investment Management, says, "You can really take advantage of monetary cycles that are not in sync with the U.S." For example, 10-year Brazilian sovereign bonds recently had 10% yields, and South African sovereign debt had 7.7%. Last year's poor performance isn't all bad news. "It creates opportunity," says Divino's colleague at ING, Matt Toms, head of U.S. public fixed income. "We believe emerging market growth is likely to prove persistent."

* **Senior secured private debt.** Several planners say they are using senior secured private debt to generate returns of 6.5% to 7%. This market has opened up to investors as banks have shut down on financing to all but their largest clients.

"For public companies it's very easy for them to access capital," says Adam Sherman, CEO of Firstrust Financial Resources in Philadelphia. "They can issue a new stock and go to the marketplace. Middle-market private companies - and there are a lot of household names that fall into this category - are companies that have elected for whatever reason to not be public companies now. They are looking for third parties to get money from."

These companies are finding their financing through large asset management houses and private equity firms like Blackstone Group and KKR. The loans are fully collateralized, a big part of their appeal, Sherman says.

"When G.M. went bankrupt, the senior secured people got back 100 cents on the dollar while the common stakeholders or stockholders got back nothing," he says. "If there's a run on these private companies and they are not able to pay back the capital, that's another potential risk in the funds. But if you are working with larger shops like KKR and Blackstone, they have done a really good job of

recovering 95 cents on the dollar." Sherman says he has been using this debt market for the past 12 months. McLarty is just about to enter it. "With the right structure, these loans can present a great opportunity for an investor and really add to the overall yield of a portfolio," he says.

EQUITY OPTIONS

Planners should also be suggesting lower-risk equity options for their soon-to-be-retiring clients. These include:

* **High-dividend equities**. Aside from high-yield bonds, perhaps the most common vehicles used to create more fixed income are high-dividend equities. "You've seen a pretty good run in the prices of high-dividend equities," ING's Toms says. High-dividend equities planners might treat as similar to fixed-income investments could include REITs, utilities and business development companies, which tend to be hedged the same way fixed-income would.

Many experts told FP that they had exited Europe, often entirely, because of the debt crisis there. But Ciocca says he uses a European strategy for dividend-paying stocks - albeit one that is based in the United States. In appropriate client portfolios, he has 5% to 10% invested in the American depository receipts of the largest European companies. Large European concerns that issue ADRs include French oil company Total and British-Dutch consumer goods giant Unilever.

"Some European firms use a U.S. listing, so they can raise capital - and they can be phenomenally profitable," generating dividends of 3.5% to 5%, Ciocca says. "That is an economy complement to our fixed-income strategy."

* **Master limited partnerships**. Some planners shy away from partnerships of any kind because of the lack of control that they afford investors and the complexity involved with receiving K-1 forms instead of 1099s at tax time. Yet others like one particular breed of partnership - the master limited partnership, which typically invests in hard assets like pipelines for oil field transportation.

"We think they offer good income potential at 5% vs. 2%," in bonds, says Frank Germack III, director of the capital management group at the Troy, Mich.-based Rehmann Financial. He says he gets around the K-1 issue by buying exchange-traded notes that own the MLPs instead of buying the partnerships directly; ETNs issue 1099s.

But Germack cautions that master limited partnerships "tend to be focused on the energy sector." Second, "there still may be some correlation with interest rates. If interest rates rise, this income may not mean as much," he adds.

In his practice, McLarty says he uses five master limited partnerships, which he classifies as alternative investments and which pay rates as high as 5% to 7%. "BP might lease a pipeline to ship oil and gas from one place to another," he says. "Then the money they pay an MLP has to pay out 90% to 95% of revenues to shareholders as a dividend." McLarty adds, "They typically hold up really well in a rising inflationary environment."

One of his master limited partnerships invests not only in oil and gas infrastructure but also in for-profit prisons, railroads and timber infrastructure. He cautions that planners need to understand how they are structured and how much money they are required to pay out.

TRUSTS AND ANNUITIES

There are two other strategies that may make sense in today's fixed-income enviornment: charitable trusts and insurance annuities.

* **Charitable trusts**. Tax breaks for two kinds of charitable trusts can help high-net-worth clients off-load highly appreciated assets tax-free. They also turn them into a charitable donation while creating an income stream they can count on.

With a charitable remainder unitrust, a client can donate stock or a highly appreciated piece of real estate or other asset to a charity. In return, she might receive 6% annually of the value of that gift. This kind of trust leaves the client exposed to some risk, however. Every year, the amount of the client's annual income stream adjusts based on the updated value of the gifted asset. If it increases, so does her annual income. If the amount falls in value, however, her income falls, too.

A better bet these days may be a charitable gift annuity trust. In this case, a donor gives assets or money to the charity in return for a guaranteed annual income stream. But, in this instance, the burden falls on the charity to manage the gift well. If it doesn't and the value falls, the charity must continue to meet its annual income obligation to the donor until the principal is exhausted.

When the markets were doing great, unitrusts were more popular. In the past few years, gift annuity trusts have been more popular. But there are risks to both. "It's really for people who have plenty of assets," Ciocca says. "When the markets became a little more insane, sporadic and a little more negative, I think a lot of people refocused their charitable giving plans. They have been doing less of either strategy in the last few years."

* **Insurance annuities**. Many planners won't touch insurance annuities of any kind, because of high cost - up to 3% or 4% - and large downside risk. But sometimes these policies can give certain clients the peace of mind they crave in the form of a reliable stream of income.

Immediate annuities require policyholders to hand over a sum of money to an insurer. In return they get a guaranteed stream of income for the rest of their lives, with varying conditions and restrictions. The gamble is that, if they die too soon, the insurer may take the entire sum paid into the policy. In theory, this could mean that one year's worth of income at $80,000, equivalent to 8% of $1 million paid to an insurer, could cost a policyholder $920,000. That is, if he dies a year after buying the policy.

But the knife cuts the other way, too. Should the policyholder live another 20 years, the insurer could end up paying far beyond the amount paid to fund the policy. Sherman says roughly 35% of his clients have 25% to 35% of their portfolios in a type of annuity called a guaranteed minimum income benefit annuity. This form of annuity reduces some of the risk of loss of principal due to a premature death by allocating income to a survivor.

Other planners say they use insurance annuities only in an extraordinary circumstance such as a client with high fixed medical costs, extreme fear of market volatility or a troublesome relative. One planner had a client who bought the annuity for a sister who would receive a fixed amount for the rest of her life, but would never be able to pick up the phone and clear out the account.

Another caution about annuities, according to Trovena's Toya, is that any income not considered return-of-principal is typically treated as ordinary income. "It's not very tax efficient," Toya says, and the small print is extensive. But, he adds, "if used right, it could be a useful thing for a client."

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