PRATO CAPITAL

The Newsletter • July 2020

Why have Fixed Income in a Portfolio?

The volatility over the past few months in the stock market has renewed investor interest in fixed income.

Investors often view the fixed income portion of a portfolio as being less volatile than stocks and one way to provide some stability to their portfolio. With low-interest rates, what is the expectation of the fixed income or bond side of a portfolio now, especially when we hear of interest rates near zero percent?

An Introduction to Fixed Income

Fixed income and bonds are often used interchangeably when discussing a portfolio. Fixed income is a broad category with bonds or bond funds the most common type investors may have in their portfolios. Much like equities, there are different types of bonds, both in the US and globally with about 32% of the global bond market in the US.

A bond represents a loan from the investor to the issuer of the bond. The issuer of the bond agrees to pay back the face value of the bond after a specific time (duration) and to pay the investor interest on the amount of the bond (yield).

Risk in bonds and the possibility of greater returns comes from longer duration bonds and issuers with lower credit ratings. Longer duration bonds can

change in value in the secondary market when interest rates change. Credit ratings are set by financial companies like Moody's and Standard & Poors.

Like with the equity portion of a portfolio, diversification within bonds is also a good idea. Diversification of the bond portfolio may include both government and corporate bonds with different maturities. This can be done by purchasing many individual bonds or by investing in a bond mutual fund.

Different types of Bonds or Bond Funds can fill different roles in a Diversified Portfolio.

At Prato Capital Management, we believe that all bonds and bond funds are not the same and should not be treated that way in an investor's portfolio.

Bonds and bond funds normally fill three different roles in most investors' portfolios:

1. A counterbalance to the volatility of the stock market.
2. Provide income for the investor.
3. Possible growth through capital gains and increased income.

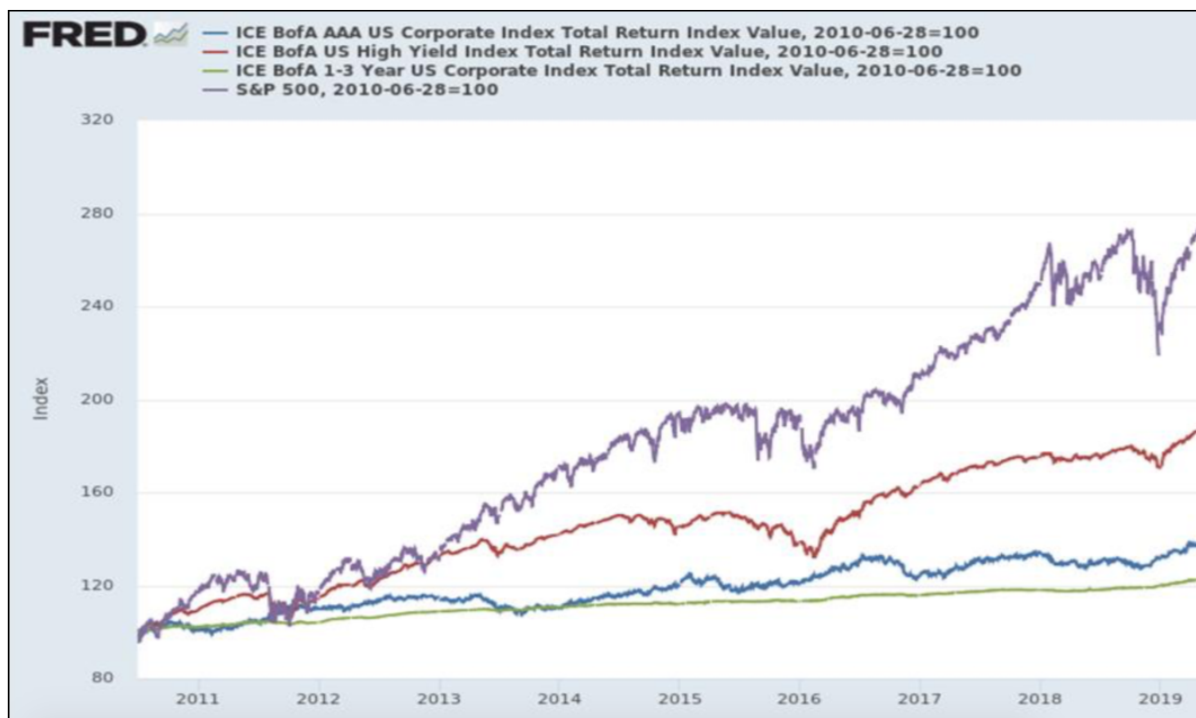
The price paid for increased gains in any investment is normally increased volatility. The same is true for both the equity and fixed income markets. With this said, volatility in the fixed income market is normally less than the stock markets.

Exhibit 1 below shows three different corporate bond indices with the cumulative change in returns over the past 10 years. Not only are the returns different for each of these indices, but the volatility is also different as well. For reference, the purple line in this chart is the S&P 500.

1. The smooth green line shows the stability of short-term bonds. Prices do not change very much daily and this reduces overall volatility.
2. The blue line is a composite of high-quality corporate bonds of all durations, both long and short-term. This line is not as smooth indicating an increase in volatility but also an increase in overall return this index.
3. The red line is an index of high-yielding corporate bonds. This index has increased in value much greater than the other bond indices. But, volatility

has also increased. When compared to the S&P 500, the volatility is significantly less.

Exhibit 1: Bond Index Returns [1]



Any of these types of bonds or bond funds can have a place in an investor's portfolio. It depends on what the investor is looking for. With short-term bonds, price stability from the bonds will lessen the ups and downs of the stock market. With high-yield bonds or bond funds, investors may see an increase in portfolio value but with less volatility than the stock market.

Conclusion

At Prato Capital Management, we believe bonds should be a part of every investor's portfolio. It is important to seek a balance not only with stocks and bonds but to reach an appropriate balance within both the bond and stock side of the portfolio. Within the bond side of a portfolio, reaching the appropriate balance between risk, volatility, and returns is very important as a balance to the equity side of an investor's portfolio.

We agree wholeheartedly with one of the founding fathers of our country:

"An investment in knowledge pays the best interest"
- **Benjamin Franklin.**

Here is a short clip of **Gregory Prato** and **Tim Paulson** from Lord Abbett discussing **High-Yield Bonds** from our webinar last month.

Thinking of you always,
Gregory, Gabriella, Brian, Chris, and Samer

References

[1] *Ice Data Indices, LLC, ICE BofA Corporate Bond Indices and S&P Dow Jones Indices LLC, S&P 500 Index retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org, June 28, 2020.*

FOLLOW US ON SOCIAL MEDIA BY CLICKING THE ICONS BELOW