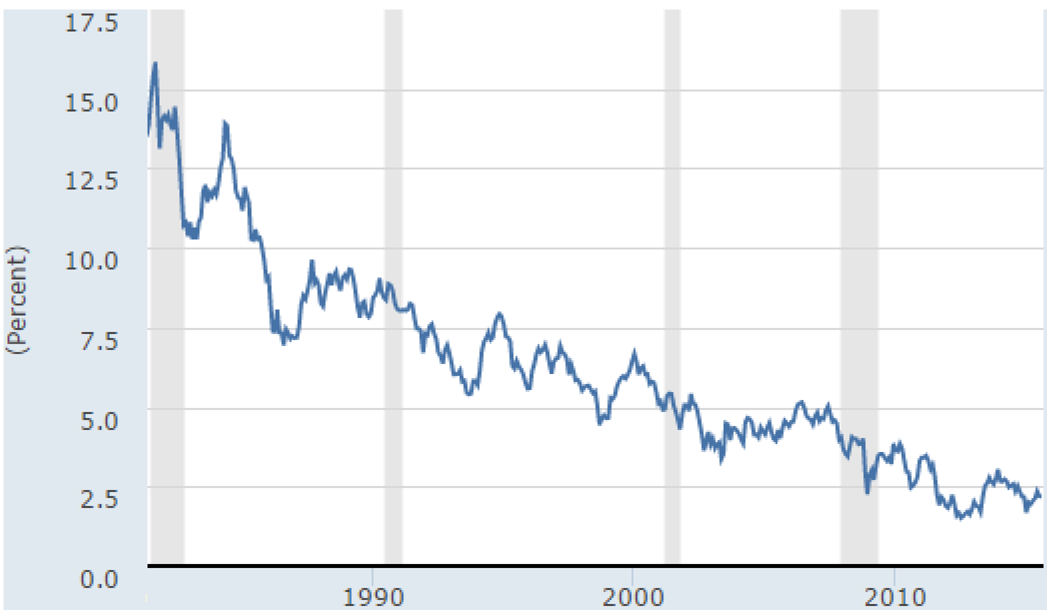
What Should I Do With My Fixed Income Allocation?

For decades, a traditional fixed income allocation was considered a relatively stable, predictable investment within a balanced portfolio. Investors could be reasonably confident in their bond portfolio's ultimate outcome and how it might respond over time, but the track record investors have grown to trust and rely on is transforming. The difference between then and now lies in the current interest rate environment. For decades U.S. interest rates have been on a downward trajectory (see chart below), through a combination of monetary policy moves, minimal inflation levels and ongoing demand for the securities. Today, the question has become: How and in what form should an investor allocate to "fixed income" in an environment of rising rates and elevated duration risk?

10 Year Nominal Treasury Rates from Sept 1981 – August 2015



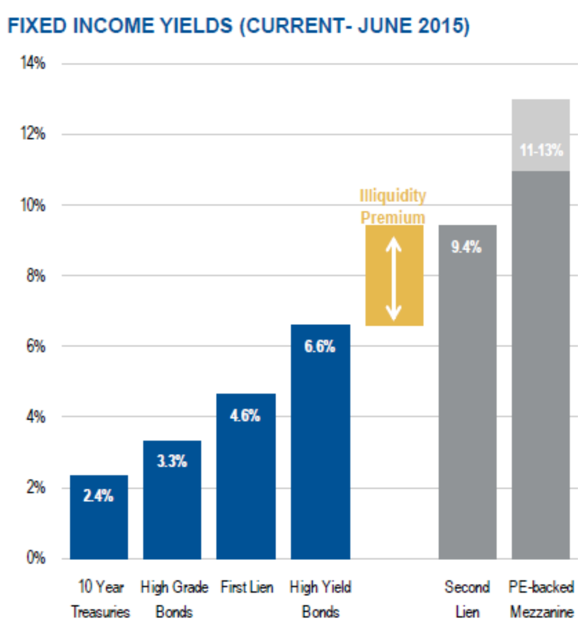
Source: St. Louis Federal Reserve

Now let's switch gears slightly. At Lynx we follow two main approaches to portfolio allocation, a risk diversification approach and the more traditional capital allocation approach. Though investors tend to diversify their assets based on specific dollar amounts (i.e. 60% equites/40% bonds), depending on the market environment, an investor may find they are left with a highly skewed, unexpected risk profile in times of stress. Specifically, though 40% is labeled fixed income, it very well may be that this allocation will act like equity and high yield credit. While this approach is completely acceptable as long as the risk allotment is understood, given where we are in the interest rate cycle today, Lynx has begun to marry the traditional approach with the risk diversification approach for a more accurate picture. Risk diversification focuses on risk per market category instead of dollars invested. These categories or market risks include interest rate (duration), market (or beta), credit (or spreads) and liquidity (easily bought/sold). The idea is to spread these risks evenly across a portfolio by weighting each asset class according to its risk exposures. Therefore, in a more volatile, rising interest rate scenario, where interest rate risk is underpriced, a risk diversification approach should produce portfolios with less interest rate risk.

Turning back to a fixed income allocation, in terms of market risk categories, we do not believe duration risk is being accurately reflected in bond prices. Or put another way, we don't think investors are being paid enough to tolerate the interest rate risk embedded in most liquid investment grade bonds today. This is not to say we don't believe in a traditional fixed income allocation at all, in fact we are in favor of a 15-20% allocation. However, in an effort to find other options that might more affectively balance our risk diversified allocation, we have begun to consider "alternative" investment options.

Though not a perfect substitute, we believe another investment that could play a similar role in terms of return expectations, while maintaining the preferred risk profile within a balanced portfolio, is a less-liquid private debt vehicle. Similar to private equity, a private debt fund asks investors to trade interest rate risk for liquidity risk. This option requires that an investor lock up capital for five to eight years (giving up liquidity), but by agreeing to the illiquidity, they are simultaneously reducing the negative effects rising interest rates tend to have on liquid, nominal bonds. Of course, for an investor to consent to a lock-up they must be compensated, which is where the all-important illiquidity premium comes in (see below chart). Ideally this approach provides an investor with the safety, security, and diversification benefits typically offered by a fixed income investment, while garnering returns that justify the risks associated with taking on an illiquid investment.

<u>Fixed Income Yields</u>



Data as of June 30, 2015. Source: Bloomberg US Government Generic 10 Year Index, Barclays Corporate Investment Grade Index, Credit Suisse Leveraged Loans 1st Lien Index; Barclays Corporate High Yield Bond Index, 3-month average new-Issue Second Lien Spread from S&P LCD (includes LIBOR floor and upfront fee), PE-backed Mezzanine from Lincoln International's Debt Advisory Group.

Lynx Investment Advisory

Now, none of us at Lynx has the elusive crystal ball and we are not in the prediction business. When the Fed will decide to make a move and when rates will actually move up in a significant way, we do not know. It is possible fixed income securities remain on a sideways course for some time; though there's not much more room for rates to come down, they may not increase either. A traditional fixed income allocation will continue to come in handy in a volatile market and during times of macro uncertainty, but what we are trying to do is position our portfolios to fit the forthcoming market environment. When evaluating a portfolio with a risk diversification lens, we feel very sure a higher allocation to traditional fixed income will do a disservice to overall returns in the coming years. In order to alleviate some of the interest rate risk we do not believe investors are being fairly compensated for, we are willing to take a less conventional approach. By not having to think about the effects of interest rates and then having the time to construct a solid, lucrative set of private loans, we believe the right private debt vehicle could be one of a few intelligent additions to a balanced portfolio diversified for risk.