Stretching For Yield...Carefully

Typically, bond funds with low yields have relatively low risk (see the *Sapient CPA Client Bulletin*, March 2018). That doesn't mean that these funds are riskless, though. With interest rates expected to rise this year, all types of bond values could drop, leading to an overall pullback in the prices of bond fund shares.

One way to respond to this unwelcome outlook is to diversify your fixed income holdings.

Example: Jane Miller has a target asset allocation of 60% in stocks and 40% in bonds. Working with her financial adviser, Jane puts half of that fixed income allocation (20% of her entire portfolio) into bond funds that mainly hold short-term issues from government entities and financially sound corporations. Such funds are likely to have low yields, but they probably will hold most or all of their value in the coming months and years.

These lower risk funds may be considered core fixed income investments.

Beyond The Norm

Assume that Jane can tolerate some volatility in her portfolio. If so, she might put the other half of her fixed income allocation into these types of bond funds:

- *High-yield funds.* These funds typically invest in corporate bonds that are unrated or low rated by specialized agencies, perhaps because the issuers are not in excellent financial condition. Fund holdings may be known as *junk bonds*. Yields are relatively high, but bond prices might drop in times of economic weakness, which can raise doubts about the companies' ability to meet interest and redemption promises. This danger, known as *credit risk*, may be reduced if the fund holds many issues because most of a professionally chosen portfolio is likely to avoid defaults.

- *Emerging markets bond funds.* Holdings include bonds from governments and companies based in areas considered to be developing economically. For example, such places could range from Brazil to Russia to South Africa. Currency movements may affect returns positively or negatively, but there might be little influence from U.S. interest rate moves.

- *Bank loan funds.* As the name indicates, such funds purchase loans made by banks. The borrowers are usually companies; frequently, the loans are used to finance acquisitions. Questions about the borrowers' ability to repay the debt make these funds vulnerable to recessions and low growth periods. On the other hand, bank loan funds generally invest in variable rate debt, so borrowers' payment obligations (and the dividends to investors) can go up when interest rates rise.

- *Preferred stock funds.* Whereas familiar stock funds own *common stock* of issuers, these funds buy preferred shares. The name indicates that investors will be paid before common stock holders, in case the issuer can't meet all its obligations. Preferred stock payouts come before dividends on common shares. In practice, preferred shares tend to pay fixed bond-like yields, and trading prices may have low volatility. Preferred stock funds can be considered more like bond funds than stock funds.

- *Municipal high yield funds.* These funds hold tax-exempt municipal bonds from issuers that do not have a sterling credit rating. In essence, these funds are the tax-exempt cousin of the high-yield funds mentioned previously in this article, which pay taxable interest.

As is the case with all municipal bonds and muni bond funds, they should be held in taxable accounts to use their exemption. The other types of funds covered here may be favored for tax-deferred accounts such as IRAs, for which the high dividend payments can compound without a current tax haircut.

Staying Put

All of the fund categories mentioned in this article have numerous entrants, so yields will vary from fund to fund. You may be able to find yields around 5% in some funds, whereas core bond funds might be yielding 3% or 2% or even less. Over a lengthy holding period, the difference between compounding a 5% yield and compounding a 2% or 3% yield can be sizable.

Moreover, bond funds tend to buy new bonds because of bond sales, bond redemptions, and new money from investors. If interest rates are rising, fund purchases will bring higher yields, whereas lower yielding bonds are replaced. Again, investors should plan on holding for the long term in order to maximize the value of using bond funds with relatively high yields.

Proceed With Caution

High yields generally mean substantial risks, so you may want to mix such bond funds with lower yielding but less volatile bond funds. You could hold funds from every category mentioned here, or you could select only one or two categories to perhaps improve fixed income returns.

If you already hold mutual funds and you're pleased with the results, you might want to see if the fund company has a high-yield fund, an emerging markets bond fund, and so on. Look at the fund's past performance, manager tenure, and investment philosophy before making decisions. The same criteria apply if you're choosing among funds from other companies on your own or if you're working with an adviser.