Are Bonds Adding to Your Equity Exposure?

- As the article outlines, high-yield bonds and bank loans, also known as floating rate debt, will generally perform well during periods of economic growth.
- However, during recessionary periods or times of turmoil, U.S. Treasuries will outperform as part of a "flight to quality."

These are trying times for yield-seekers. The Federal Reserve has kept interest rates ultralow for more than two years, and Federal Reserve chairman Ben Bernanke gave no indication in his recent press conference that the Fed will depart from that stance anytime soon. That may be good news for those in the market for home loans, but it's surely unwelcome for seniors and others trying to wring a livable income stream from their portfolios. Yields on cash instruments such as certificates of deposit are barely in the black, while you're lucky to pick up a yield of more than 3% on an intermediate-term bond fund.

Given this backdrop, it probably shouldn't be surprising that some investors appear to be chasing yields. Among bond funds, some of the biggest beneficiaries of new assets during the past year have been those that offer higher yields than high-quality bonds in exchange for some extra risk.

Of course, it's highly possible that investors are making the not unreasonable bet that the economy will continue to improve, thereby boosting these credit-sensitive sectors of the bond market. (Issuers are less likely to default on their bonds in a strengthening economic environment.) But it's also likely that some investors are focusing on the potential for higher yields without paying due attention to the downside.

All market shocks are different, of course, but they're often characterized by a flight to quality that puts pressure on credit-sensitive securities such as high-yield bonds and bank loans. During the period from mid-2007 through December 2008, for example, both high-yield bond funds and bank-loan funds performed poorly. This precipitated an unprecedented buying opportunity in credit-sensitive bonds, but following a more than two-year run-up in such securities, valuations aren't what they once were.

In addition to considering the risks, investors who are venturing into credit-sensitive bonds at this juncture should also be aware of what they might not be getting: diversification, particularly if they're looking to bonds as an antidote to an equity-heavy portfolio. It's true that credit-sensitive sectors like high yield and bank loans can be considered a good diversifier for portfolios that are skewed toward high-quality fixed-income securities such as government bonds, mortgage-backed securities, and high-quality corporate debt.

The high-yield sector's performance correlation with the equity market has been strong during the past decade (this means that, whether rising or falling, they tend to move together). The correlation of bank-loan funds with stocks has also been relatively strong (although less so than that of high-yield bond funds). Both asset classes have been more highly correlated with stocks than with bonds.

Does that mean you should reflexively avoid high-yield and bank-loan funds? Not necessarily. These bonds do provide some diversification benefit to high-quality bonds. And while high-yield bonds wouldn't be impervious in a period of rising interest rates, their extra yield cushions would most certainly hold them in better stead than gilt-edged Treasuries in such an environment. And bank-loan funds offer built-in protection against rising interest rates. If the economy continues to strengthen, high yield and bank loans would likely continue to chug along. But it's also a mistake to assume that a bond is a bond is a bond. If you're looking at mutual funds that delve into credit-sensitive sectors, it's crucial to thoroughly understand a prospective holding's strategy and downside potential before adding it to your portfolio.

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not ensure a profit or protect against a loss in a declining market.