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White paper: When can risk mean opportunity?

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There's more to bond investing than interest rates. And understanding the four key risk factors can help investors navigate the fixed-income market.

A basic principle of fixed-income investing is that when interest rates rise, bond prices fall, and vice versa. And this interest-rate risk, or duration risk, is what most investors think of when investing in bonds.

But the fixed-income market is more complex than that, and there's more than just interest-raterisk to consider. By breaking bonds down to their most basic components, today's investors can gain a better understanding of the factors that generate risk and return. A better understanding of these drivers can help investors navigate changing market conditions.

LEARN MORE ABOUT HARNESSING FIXED-INCOME RETURNS

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GENE TANNUZZO, CFA,
SENIOR PORTFOLIO MANAGER

GORDON BOWERS III, CFA,
ASSOCIATE RESEARCH ANALYST

Highlights

- There are four unique, major fixed-income risks — duration, currency, credit and inflation — and different fixed-income investments respond to them differently.
- Applying a full understanding of the four risks to a fixed-income portfolio may yield a better risk/return outcome.
- A multi-sector fixed-income portfolio based on the four risks may succeed where some binary risk allocation strategies are presently failing.

WHEN CAN RISK MEAN OPPORTUNITY?
HARNESSING FIXED-INCOME RETURNS THROUGH THE CYCLE

The fixed-income market has become increasingly complex. Drivers of returns across bond portfolios are less transparent, dashing investors' return expectations in various environments. Much of this results from bond investors not knowing what they own.

By breaking bonds down to their most basic components, today's investors can gain a better understanding of the factors that generate risk and return. A better understanding of these drivers can help investors navigate the current market and build bond portfolios that can generate attractive returns through the cycle.

Depending on where we are in the economic cycle, different types of bonds offer attractive risk opportunities.

Fixed-income asset classes respond to risks differently

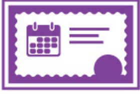
It is easy for an investor to misunderstand the risk associated with a fixed-income investment, but this can have significant portfolio strategy implications. A look at the risk composition of some common bond indices is revealing (Exhibit 1). For most domestic, investment-grade indices, an investor should expect most of the risk to come from duration, or interest rate risk. This is not surprising when you consider that the Bloomberg Barclays U.S. Aggregate Bond Index has a large portion of its market value in government-backed debt. However, investors in Treasury inflation-protected securities (TIPS) or investment-grade corporate bonds may be surprised to learn that much of their return is still derived from duration, because changes in government bond yields explain a large portion of the return of these high-quality asset classes.

The story changes further down the risk spectrum. Below-investment-grade securities like high-yield bonds and bank loans derive most of their volatility from credit risk because changes in corporate credit metrics and default probabilities

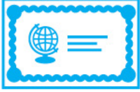
Gene Tannuzzo, CFA
Deputy Global Head of Fixed Income

Understand the risk factors in the bond market

A risk factor is an independent market variable that helps explain the return of an investment. While "risk" often carries a negative connotation, it also represents positive return potential. In the bond market, there are four unique, major risk factors that can drive performance:



Duration, or interest rate risk, represents the price volatility of a long-term investment as prevailing market interest rates change.



Currency risk is driven by fluctuations in exchange rates.

Credit risk represents the risk of default for lending to a private corporation, consumer or risky sovereign country.

Inflation risk is driven by actual and expected changes in consumer prices.

Emphasize different risks at different times

Not all bonds respond to these risk factors in the same way. Each risk factor is unique, and bonds that are sensitive to these four basic risk factors behave differently in the various phases of the economic cycle. For example, credit risk is more attractive in periods of strong economic growth, but it's less attractive when economic growth is slowing, which causes financial conditions to tighten and default risk to rise.

Bottom line

Depending on where we are in the economic cycle, different types of bonds offer opportunities beyond only duration. A flexible fixed-income strategy can find the right mix of risk, and potential opportunity, as market conditions change.

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