Balancing Act: Maintaining Liquidity and Purchasing Power with Short Term Bonds

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Investors globally are walking a tightrope today, balancing risk-taking and risk management. As growth appears poised to slow, the outlook for financial markets remains uncertain—a situation compounded by increased cost of capital, tighter financial conditions and heightened market volatility.

For some investors, the right balance can likely be found at the front end of the yield curve. An actively managed short-term bond strategy (which in the U.S. could include tax-efficient municipal bonds) may offer:

- Potential defense against volatile markets
- Improved liquidity for current and future spending needs versus longer-duration bonds
- Optionality to move to higher risk allocations opportunistically
- Incremental return and income potential above that of traditional cash investments with only a modest increase in risk

Achieving balance

Investors seeking attractive returns while also preserving capital need to weigh different concerns in today’s markets.

Balancing growth and interest rate expectations. While U.S. growth so far remains steady at over 2%, the Federal Reserve has communicated that the policy rate is now near neutral, and Fed officials appear to be shifting their focus to lifting inflation. In this somewhat uncertain rate environment, investors need to be flexible. Short-term bonds can offer low duration, or limited exposure to interest rate risk, and the potential for total returns above traditional cash investments with only a modest increase in risk, which can help protect the purchasing power of investors’ assets. The short-term asset class (proxied by the Bloomberg Barclays 1–3 Year U.S. Government/Credit Index) is yielding 2.66% currently, which is above the S&P 500 dividend yield of 1.93% and close to the 10-year U.S. Treasury yield. For U.S. investors, the short-term muni sector (proxied by the Bloomberg Barclays 1-Year Municipal Bond Index) currently offers a yield-to-worst of 1.80% and tax-equivalent yield of 3.04%.* An actively managed short-term strategy can boost yield potential further and also seek opportunities for capital appreciation in an effort to increase total returns.
Balancing returns and volatility. Volatility has risen recently, in part due to tightening financial conditions. The sell-off in equities and other risk assets in November and December illustrated that investors have a much lower tolerance for risk than previously perceived. Short-term bonds may offer a lower-volatility option and minimize drawdowns during periods of market stress relative to higher-risk assets. During turbulent markets, actively managed short-term strategies aim to manage credit and other risks, diversifying exposures across other high quality segments of the market, such as securitized mortgages or asset-backed securities.

Balancing defense and offense in liquidity. In this late-cycle environment, maintaining liquidity can be a crucial defense for investors. During times of market stress, like November and December of 2018, investors can also become liquidity providers, seeking to buy assets at attractive prices and opportunistically sourcing returns for their portfolios. An actively managed short-term strategy can manage liquidity and opportunistically seek to identify attractive return potential.

A balanced solution

For investors seeking balance in their portfolios amid volatility and uncertainty, a taxable or municipal short-term bond strategy can offer a relatively simple way to help lower overall portfolio risk, seek to generate income and maintain improved liquidity over riskier assets.

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DISCLOSURES

*Taxable-equivalent muni yield is based on the Bloomberg Barclays Municipal Bond Index. A federal tax rate of 37% and a Medicare tax rate of 3.8% were used to apply an aggregate tax rate of 40.8%. PIMCO does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax or legal questions and concerns.

Municipal data was sourced from Barclays Live and is as of 31 January 2019.

All investments contain risk and may lose value. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Income from municipal bonds in the United States is exempt from federal tax, but may be subject to state and local taxes and at times the alternative minimum tax. Management risk is the risk that the investment techniques and risk analyses applied by an investment manager will not produce the desired results, and that certain policies or developments may affect the investment techniques
available to the manager in connection with managing the strategy. **Diversification** does not ensure against loss. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.