Get Active In Your Bond Portfolio
by Michael Schmidt,CFA (Contact Author | Biography)

While a buy-and-hold strategy can provide income from a bond portfolio, the strategy for getting the optimal potential out of any bond portfolio is active management. The goal of an actively managed portfolio is to achieve greater risk-adjusted returns than a buy-and-hold strategy. As bonds have become an even more important asset class, associated with reducing overall portfolio risk, the technological advances, modeling techniques and rapid data dissemination have grown in the business. The business of active bond-portfolio management has evolved, and the styles of management have become more sophisticated (including two blended portfolio-management strategies, indexation and immunization). This article will focus on different active-management strategies you can use to get the most from your bond portfolio. (For more on active management, read *Words From The Wise On Active Management*.)

Differences
The main difference between passive and active management is the assumption that the portfolio manager, whether it be a large institution or an individual, has the ability to either predict the direction of interest rates or exploit mispriced securities. While the manager does not have to be correct 100% of the time, he/she must be successful enough to provide returns in excess of a passively managed portfolio, minus transaction costs, taxes and management fees. Otherwise, you could just live off your own couch potato portfolio and put them all out of a job. (To learn more about creating a couch potato portfolio, see *How Portfolio Laziness Pays Off*.)

In order to achieve these results, there are at least four active styles to choose from:

- valuation
- interest rate anticipation
- yield spread
- bond swaps

Each strategy can be deployed across the entire bond universe or specifically to investment-grade, high-yield, international and municipal bonds for tax-sensitive investors. These strategies can be used independently or simultaneously. (Read more about the tax benefits of municipal bonds in *The Basics Of Municipal Bonds* and *Bond Market Pricing Conventions*.)

Valuation Strategy
The basic premise of valuation is based on the portfolio manager's ability to identify and purchase undervalued securities and avoid those that appear to be overvalued. This takes some experience and in-depth knowledge of the bond markets, and can be done on a large scale or across a handful of bonds. As most bonds trade off of a spread to the U.S. Treasuries, their market price usually reflects the difference in rating, maturity or both.

For example, take five bonds of the exact same credit rating, maturity, industry and liquidity. Using a required yield to discount the future cash flows, all else being equal, one bond may be pricing out lower than its intrinsic value. While this goes against the theories of efficient markets, the ability to exploit slight deviations in price can add to significant overall returns. (Read more about alternative theories in *What Is Market Efficiency?*)

That slight deviation can be caused by any number of inefficiencies, up to and including a temporary lack of demand or the intrinsic value of embedded options. These options can have a perceived value or lack of value from one investor to another. The goal here is to exploit those inefficiencies over and over again in a dynamic environment.

Interest Rate Anticipation
Interest rate anticipation is one of the most common - and probably riskiest - strategies, since it relies on forecasting. When the Federal Reserve is in a loosening or tightening mode, it can be clear as to the general direction of rates, but it is the turning points where anticipation earns its keep. (For more information on the Federal Reserve, read *Formulating Monetary Policy*.)

Since duration is a more accurate metric to measure volatility, it is used to adjust the portfolio. Duration is lengthened in an effort to capture an increase in value when the prediction is that interest rates will fall. Conversely, if interest rates are expected to rise, the move would be to shorten the duration of the portfolio to preserve capital and potentially reinvest in shorter-term bonds when rates are presumed to be higher. (Read more about anticipation in *Anticipation Vs. Prediction*.)

Of course, the risk lies again on the presumption of the future and the success of each adjustment. This strategy can significantly enhance returns with the correct forecasting, but can drive an investment-grade portfolio into the ground if poor bets are made.

Yield Spread Strategy
Yield spreads are determined by the pricing of bonds in various segments of the market. The unique characteristics of the bonds relate to the varying prices and related yields.

These characteristics can include:

- *Term to maturity* - Maturities within a specific segment typically spread across the yield curve if it is not flat. When the yield curve is upward sloping, longer-maturity bonds have higher yields, and the opposite is true in downward-sloping environments. (For more information on bond yields, read *Bond Yield Curve Holds Predictive Powers*.)
- *Coupon payments* - Different coupons across segments can also carry different prices due to their demand and liquidity.
- *Sectors* - Bonds across different sectors with the same credit ratings may be priced differently for many reasons. An example of that would be AA bonds for a regional bank vs. AA bonds for a pharmaceutical company. (Read more about bond ratings in *Junk Bonds: Everything You Need To Know*.)

- *Credit spreads* - Different bond types (i.e. Treasuries vs. corporate) tend to be priced differently, all variables held constant. (Read more about credit spreads in *Corporate Bonds: An Introduction To Credit Risk*.)

Investors have the opportunity to profit from this strategy by accurately predicting changes in spreads or changes in the term structure of interest rates. It is important to be very familiar with the implied spreads and have the ability and knowledge to move swiftly to take advantage of opportunities. As spreads tend to widen during periods of economic uncertainty, a spread specialist may take long positions in riskier bonds to capture higher yields as others flee to safety. While the coupon spread is the obvious benefit, it is the ability to predict the turning points to a certain degree of accuracy that is the key. This is where the price of a bond moves the most dramatically and most of the value added is found.

Bond-Swap Strategies

The key to a bond-swap strategy is to simultaneously sell one bond and purchase another for the sole purpose of improving the portfolio's return. While there are many variations of swaps, here are a few of the most common ones:

- *Pure yield pickup swap* - This involves simultaneously swapping out of a lower-coupon bond for a higher-coupon bond. This does not involve any predictions per se, just a move up in yield, and usually it relates to small gains each swap, especially with high-grade bonds. (Read more in *An Introduction To Swaps*.)
- *Tax swap* - This type of swap is very common with taxable investors. Like the yield swap, it is bond-specific and does not involve projections. The most basic example would be to offset a long-term gain with a loss on a simultaneous municipal-bond sale. Since the investor uses the municipal bond's tax-exempt income to lower total taxes, netting out gains subject to capital gains tax would be beneficial. (For more on bond taxation, read *Bond Taxation Rules*.)

Conclusion

The world of active management can be as simple as swapping from one bond to another to earn more yields, or using very complex modeling techniques to exploit market inefficiencies. Whichever strategy is employed, the main goal of all of them is the same, to increase total return for the portfolio. While it is common for individual investors to use more basic strategies, like a buy-and-hold ladder, it behooves them to explore how a professionally managed portfolio would trade. While all of the strategies can add value, they need to add enough value to cover both transaction costs and management fees to make them worthwhile.

For related reading, check out *Active Share Measures Active Management*.

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Michael earned an MBA from Loyola University of Chicago and is a CFA charterholder. He has spent 20 years working for management and consulting fields, such as William M. Mercer, INDATA and Coastal Asset Management. His roles there included asset allocation and integration of pension investment assets. Michael has his own finance website, Invest Safe.