MONEY IN MOTION: IT'S NOT ABOUT RETURN ON PRINCIPAL, BUT RETURN OF PRINCIPAL

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In this challenging financial market and investment landscape, I wanted to start a series of "Money in Motion" blogs, to offer up insights for fixed income positioning. The first in the series reflects where we are at the present. In other words, it's not about return on principal, but return *OF* principal.

Given what has transpired in the money and bond markets over the last two weeks, the aforementioned age-old adage should not come as much of a surprise. The declines in a whole host of fixed income markets, and signs of growing dislocations in the funding arena, have left investors in a state of fear, the likes of which we haven't seen since the financial crisis. The good news is that the Federal Reserve (Fed) has been proactive in its policy approach. But, as I've written on numerous occasions over the last few weeks, monetary policy can't turn the economic and financial tide all on its own. Meaningful fiscal policy responses need to be implemented as well.

The widening in credit spreads and general risk-off trade has not been the most surprising turn of events of late. However, fixed income investments that were thought to be safe-haven plays—namely, ultra-short and short duration strategies—were not all created equal. These strategies offer two distinct options. The first focuses exclusively on the U.S. Treasury (UST) market, and comes in two forms: fixed rate or floating rate. The other option includes credit, and more often than not, a heavy concentration in the Financials sector.

Unfortunately, investors discovered last week that the approach involving credit can behave in an unexpected manner. In highly charged risk-off periods, this approach can be overtaken by the negative dynamics concerning credit, overwhelming the rate aspect of the instrument. This is exactly the result investors were trying to avoid. The UST option, backed by the full faith and credit of the U.S. government, typically may lag the credit approach in terms of yield. But as we witnessed, this is obviously for a reason. However, keep in mind the fixed-rate aspect can still contain an element of interest rate risk while the floating rate aspect does not.

So, what are fixed income investors to do? The current money and bond market environment has afforded investors the opportunity to review their fixed income asset allocations. Once the dust does settle, our base case looks for interest rates to begin retracing their recent declines. If the recent volatility is any indication, it could happen rather quickly. The UST floating rate strategy eliminates the potential for further credit risk while also mitigating the potential for rate risk. In our view, this strategy provides investors with a solution for not only the near-term outlook, but for the horizon as well.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

Volatility : A measure of the dispersion of actual returns around a particular average level. .