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PREMIUM - MARKETS

How to lock in the potential for attractive, high-income returns from low-risk bonds in an inverted yield curve, according to a portfolio manager

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- **Taylor Huffman suggests a macro-agnostic approach to bond investing in this uncertain economy.**
- **Huffman recommends a barbell strategy, balancing exposure by betting on opposite ends.**
- **This can include munis, US Treasurys, and asset-backed securities.**

SUPPLIED BY PT ASSET MANAGEMENT

Taylor Huffman

When investing in bonds, the macroeconomic environment is often more relevant than it is for equities because the correlation is more direct: A rising fed funds rate increases the yield on newer bonds while dropping the price on older ones.

But in an uncertain economy where interest rates have risen at the fastest pace since the 1980s, trying to predict the future is a fool's game, says Taylor Huffman, a client portfolio manager at PT Asset Management.

"Everyone has been betting on rate cuts and when they're going to happen, and it keeps getting pushed off. There's a lot of uncertainty on when it'll happen, how it'll happen, why it'll happen," Huffman said. "Just to poke fun a little bit, the Fed is as inaccurate at forecasting when these rate cuts will happen. And that's seen by the dot plot and their own inability to predict when interest rate cuts are going to happen."

The alternative is a macro-agnostic approach to bond investing to eliminate all the noise.

Rather than trying to predict where interest rates will go, you can build a bond allocation for all scenarios. Sounds complicated, but there are only three directions rates can move: higher, lower, or remain the same. Based on that, you can account for these scenarios and create a barbell strategy, which means balancing exposure by betting on the opposite ends of the spectrum somewhat equally to balance the risk, she noted.

There will be bonds and sectors that do very well in a falling interest rate environment and others that do better if rates rise.

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When the yield curve is inverted, meaning short-term rates are above longer-term ones, a barbell strategy in bonds means betting on long- and short-duration bonds. It balances the reinvestment risk that's experienced at the short end of the curve—if the bond matures and the newer yields are lower—with interest rate risk that's experienced at the long end of the curve, she said.

"If you think of a barbell, like in actual strength training, if you have the image in your mind, it's heavily allocated to one end of the bar and the other end of the bar. And that barbell is kind of what investing in the yield curve looks like today", Huffman said.

This means investors should avoid the five- to ten-year part of the curve, she noted. Instead, roughly 50% of bond allocations should be at the short end of the curve and roughly 50% at the long end of the curve.

For example, short-term Treasury bills between one and six months yield north of 5%.That's very attractive, she said. But if interest rates fall, you will be forced to reinvest in a lower interest rate environment. You counter that risk by owning long-duration bonds. In this instance, that's the 20-year Treasury because it has the highest-yielding tenor, she noted.

Avoid the 10-year or 30-year duration bonds because they will face a negative yield curve roll, which could reduce their total return potential, she added.

PT Asset Management's flagship fund is the Total Return Bond Fund (PTIAX). On the long end of the curve, it's heavily weighted toward taxable municipals at 16.04% and US Treasurys at 15.93%, with some investment-grade corporate bonds. The majority, or about 39%, are AAA credit quality bonds, representing the highest credit score and lowest risk. It also has AA-rated bonds at 21% and A-rated bonds at about 14%. Less than 13% of the fund is non-investment-grade or high-risk bonds.

The short end of the curve, where duration is up to three years, it's made up of asset-backed securities, collateralized loan obligations (CLO), and non-agency commercial mortgage-backed Securities (CMBS).

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