FIXED INCOME IN 2014

Challenges for passive fixed income investors are on the rise. Adaptability and flexibility will be critical to portfolio positioning as gains are likely to prove more elusive as the year progresses. Yields remain near historical lows, with higher price volatility, particularly among longer term exposures, anticipated. And where attractive spreads variously drew interest to corporate bonds over the past half-decade, there are likely to be fewer opportunities for growth through capital gains. Pun intended, investors are thus more broadly left to the inclinations of the yield curve.

YEAR-TO-DATE GAINS

Investors generally were net sellers of bonds last year. This year, flows have been more balanced into bonds and equities. The fixed income asset class generally has benefitted from this trend, in addition to the reduced angst over the end of quantitative easing and increased geopolitical instability.

The Innealta Investment Committee in several stages positioned the portfolios defensively in 2013. Though the decisions led to duration underweight, versus the benchmark, the Team retained portfolio exposure to credit; spreads have continued to hold historically low levels, thereby allowing the portfolio to pick up additional yield. The Committee remains particularly mindful to spread duration, coupled with the declining quality of issuers in the longer tenor high yield space. Hence the emphasis on the short end of the duration spectrum among present domestic credit exposures within the portfolios.

RISING PRESSURES

With the Federal Reserve well on course to taper its quantitative easing program to zero by year end, one wonders who will step in to support what is likely to continue to be relatively massive issuance of new and rollover debt by the Federal government. The Federal deficit is expected to drop significantly this year. Even with the decline in deficits, the nation's debt is expected to expand. This trend will increase pressure on rates to move higher.

Importantly, given such low levels of yield, and in light of the forces at play (e.g. Fed tapering and still large federal budgetary deficits), the upside compensation for duration exposure has not been sufficient to warrant significant exposure. The Investment Committee readily will admit an inability to time perfectly the end of the secular decline in benchmark rates. Nonetheless, we can recognize when yields are so anemic and duration risk so high (due to low yields) that the tradeoff is unattractive and it makes sense to realign portfolio exposures ahead of the curve, so to speak.

Even so, the Investment Committee maintains that risks remain significant in 2014, with Mr. Putin only one source of potential angst among capital market investors. These risks could act as a heavy lid on rates in the short to medium term. A heightening of tension among the Soviet Union's former properties could continue to prompt a flight to safety.

Nonetheless, rising geopolitical risk is not a lasting source of downward pressure on interest rates. The Investment Committee therefore will seek a careful balance between exposure to credit and duration. Fixed income sector selection will seek to enhance yield, improve diversification and maintain conservative posturing to minimize volatility from spread widening and term structure steepening. This approach has seen the Committee choose to forgo exposures offering higher yields in the longer tenor segments of the U.S. market, given concerns over declining quality and longer exposures to rates and spreads, and instead focus on exposures with more attractive returns-to-risk tradeoffs.

IMPORTANT INFORMATION

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