



FROM THE DESK OF
PATRICK BAUMANN, CFA®
CHIEF INVESTMENT OFFICER

Our View: Fixed Income Investments

HOW TO BALANCE THE NEED FOR LIQUIDITY WITH THE NEED FOR A YIELD THAT OUTPACES INFLATION IN TODAY'S MARKET

Most investors have at least a portion of their total portfolios allocated in fixed income. Some do this to ensure diversification and reduce risk from fluctuating equities, while others do it to generate a relatively steady cash flow or fund future liabilities. As a result, fixed income investments are among the largest asset classes in the financial markets.

The spectrum of fixed income investments is broad, ranging from money markets to bond funds, publicly traded securities and even privately placed securities. Yields can vary greatly, as can duration—from just a few days to several decades. As most investors know, there a negative correlation, or tradeoff, between liquidity (related to duration) and yield.

Sorting Out Options

Now, with fixed income yields at historic lows, many investors are trying to find investments that give them the level of liquidity they seek—often requiring shorter durations—with a yield that is high enough to outpace inflation.

Analyzing the source of expected returns is key. This allows investors to better appreciate the types of risk they are taking.

Highly liquid fixed income securities have lower yields than most bonds. Therefore, investors seeking a higher yield may have to sacrifice some liquidity and duration exposure. Fixed income duration

Liquidity requirements, risk tolerance, yield expectation and duration exposures are among the factors that should be considered when selecting fixed investments for a portfolio.

generally measures the sensitivity of the fixed income instrument to a change in interest rate.

Money market funds offer the most liquidity as they invest in high quality, short term debt securities that pay dividends. They have generated great interest from investors, as they have reached about \$4 trillion in total

market value. Generally, money market mutual funds seek to maintain a stable net asset value (NAV) of \$1.00. Such funds are very popular with not only retail investors but also institutions including publicly traded companies and financial institutions.

FourThought

Research and White Paper Series

January 2020

Page 2 of 4

It's worth noting that during the 2008 financial crisis, one money market fund fell below \$1 in value and several other funds required sponsor support to avoid falling below that. This taught us that money market funds are not fail-proof, and that their underlying assets and duration must be analyzed just like any other investment.

Money Market Yields Not Keeping Up with Inflation

For today's investors, one of the chief issues related to money market funds is that most of those with a fixed NAV, investing in government securities and other high-quality short-term securities, generate a yield below the rate of inflation—thus reducing purchasing power and the ability to preserve capital. Many believe (and some rightly so) that achieving inflation-beating yields requires a longer duration and undesirable liquidity risk.

This is particularly problematic when the Federal Reserve is increasing rates. Such moves can also result in significant headwinds for bond funds. However, the fourth quarter of 2019 brought some optimism to fixed income investors since the Federal Reserve indicated that they would put rate increases on hold or “pause.”

In Challenge Comes Opportunity

Here at FourThought, we believe the Fed's pause could be an opportunity to take a small duration exposure move for better returns. Under the current market conditions, a fixed income portfolio comprised of a **blend of a money market fund and a short-term bond fund** could be a pragmatic approach to maintaining a desired level of liquidity—and at the same time, potentially earning a higher return than money market mutual funds or ultra-short bond funds alone. In other words, investors could benefit by applying the corporate finance principles of bifurcating operating cash versus strategic cash.

Multi-Horizon: Annualized Returns Chart



12/30/2016 to 12/31/2019 (M) Currency: USD Benchmark: Consumer Price Index - Seasonally Adjusted Annualized Return

Description	Annualized Return	
	1 Year	3 Year
Fidelity Govt Cash Rsrvs	1.90	1.32
BLENDED	5.25	3.05
Federated Ultrashrt;Inst	3.74	2.42
Consumer Price Index - Seasonally Adjusted	2.29	2.11

Fourthought

Research and White Paper Series

January 2020

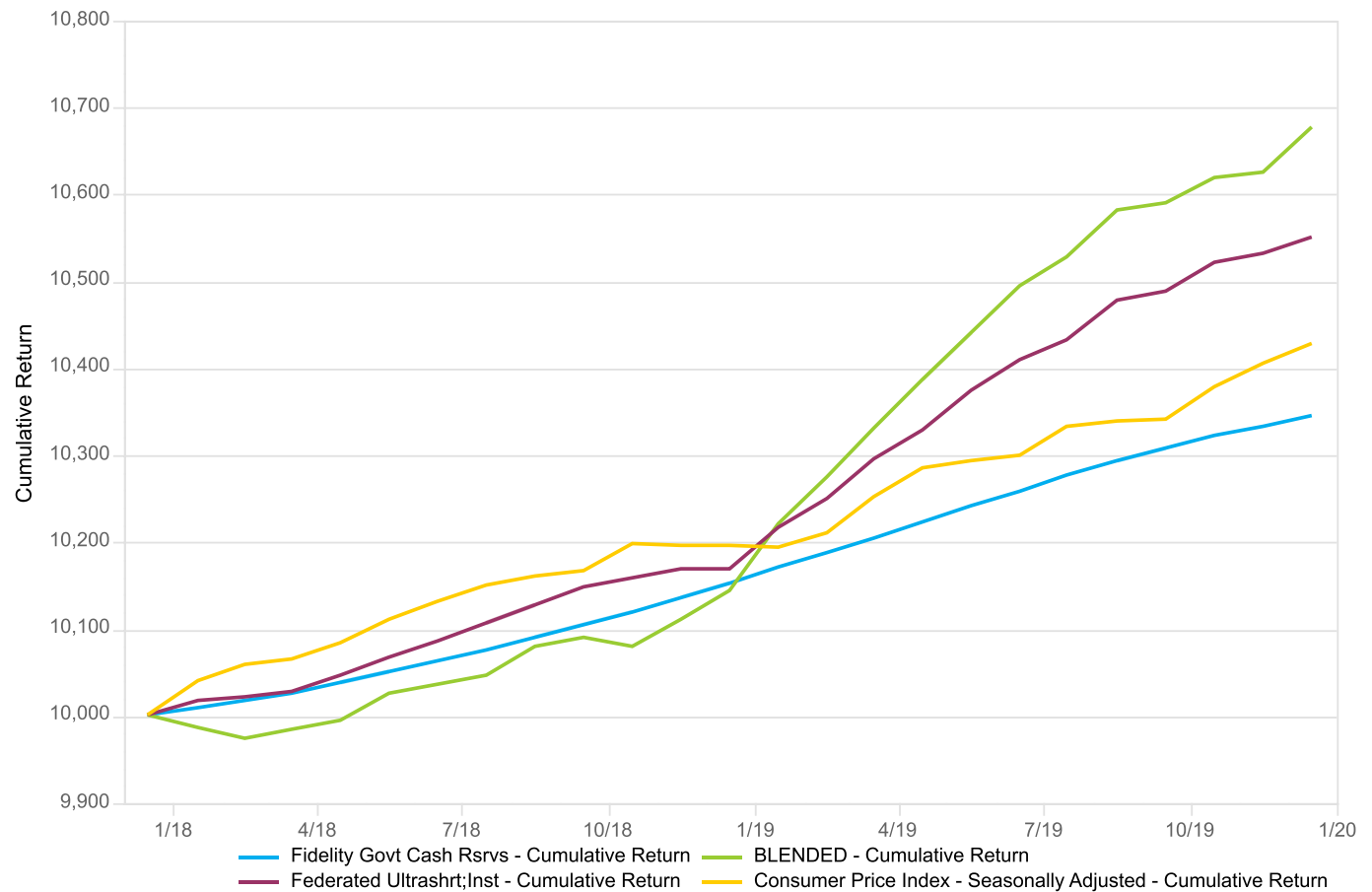
Page 3 of 4

12/29/2017 to 12/31/2019 (M) Currency: USD Benchmark: Consumer Price Index - Seasonally Adjusted Multiple Statistics

Description	Annualized Standard Deviation	Beta	Alpha	
Fidelity Govt Cash Rsrvs	0.10	-0.05	0.15	
BLENDED	0.83	-0.43	0.35	
Federated Ultrashrt;Inst	0.46	0.08	0.21	
Consumer Price Index - Seasonally Adjusted	0.46	1.00	--	

Growth of 10,000

12/29/2017 to 12/31/2019 (M) Currency: USD Benchmark: Consumer Price Index - Seasonally Adjusted Cumulative Return



Fourensics

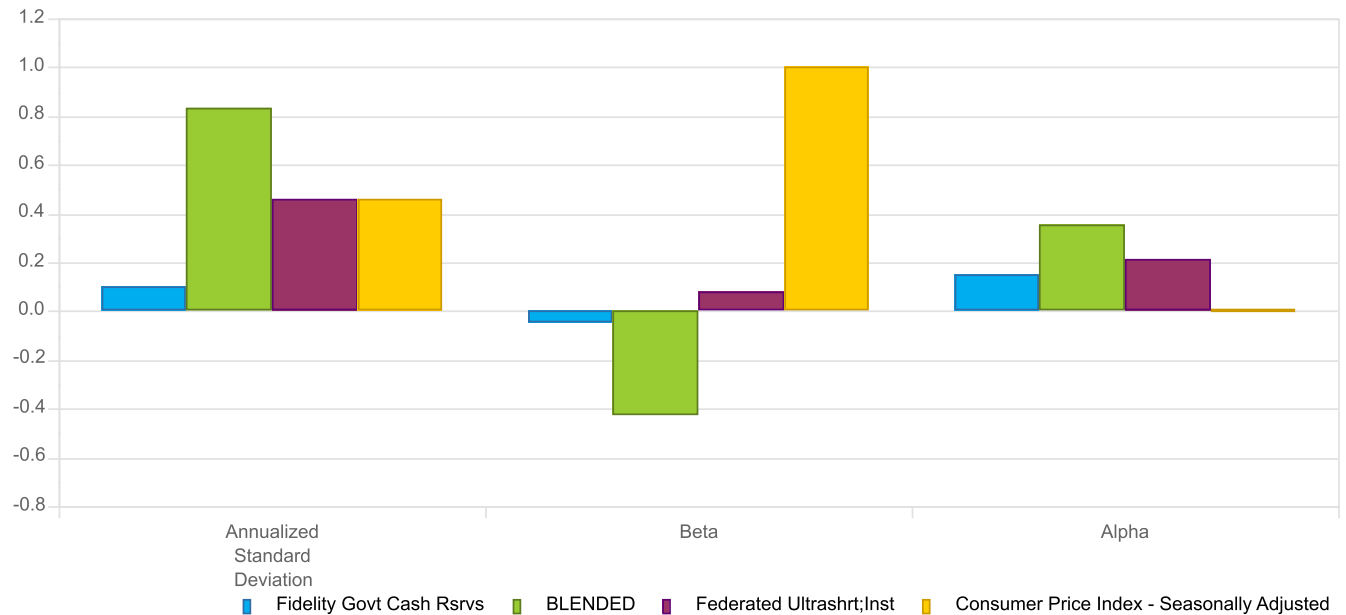
Research and White Paper Series

January 2020

Page 4 of 4

Multi-Statistic Column Chart

12/29/2017 to 12/31/2019 (M) Currency: USD Benchmark: Consumer Price Index - Seasonally Adjusted Multiple Statistics



The information provided in this white paper is obtained from sources believed to be reliable. No guarantee is made as to its accuracy or completeness. Due to rounding to the nearest dollar, the market values and percentages associated with individual positions or asset classes reflected in this white paper may not always add up to their reported totals. This material is published solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell any security or investment product. Opinions and estimates are as of a certain date and subject to change without notice. Past performance is no guarantee of future performance.