



# What is the Fixed Income Market?

## Key Takeaways

*We believe the fixed income market can offer an attractive strategy for investors seeking a systematic source of income, those looking for diversification, or those who desire a more conservative investing approach.*

*Investors can choose from an array of options in the bond market depending on their time horizon, liquidity needs, and tax status. This allows investors to pick from treasuries, corporates, municipals, mortgages, and more.*

*A bond in its simplest form is a loan from an investor. Each sector has its own characteristics and metrics that allow investors to differentiate between stronger and weaker credits. This is reflected by the credit rating, which is comparable to an individual's credit score and makes credit analysis critical.*

*The value of a bond depends on the underlying bond math. When thinking of a loan, a bond will have various terms. Among the most common terms are coupon, maturity, call date, and yield. The combination of these along with interest rates allow investors to gauge the value between various bonds.*

Interest rates, the Fed, rate hikes, mortgage rates, and inflation have all been key headlines for the last couple of years and have increased the awareness around the fixed income market. We believe the fixed income market remains an attractive investment strategy, especially after the Federal Reserve raised its benchmark rate to its highest level in 22 years. The fixed income market includes several types of bonds, such as corporates, treasuries, municipals, and mortgages. Investors invest in the fixed income market because bonds provide a fixed or even variable payment on a semi-annual, basis, creating a systematic source of income.

Volatility has been elevated in recent years, whether you are invested equities or bonds. Bonds differ from equities because they are loans to an entity as opposed to buying a share of the entity. Bonds have two different components; on one side you have the credit of the entity borrowing the money. On the other side is the bond math that includes key terms such as **yield, coupon, maturity, and call date**.

Learn fixed income markets and how bonds can offer a reliable income stream



## Understanding Bond Investment: Yield Curve, Credit Risk, and Maturity

When investing in bonds, investors need to be cognizant of their time horizon. For example, does an investor want their money back in six-months, ten-years, or thirty-years? This will help determine where on the yield curve they want to invest. The yield curve graphs yield for certain points in time, i.e., the two-year yield will differ from the ten-year and thirty-year yield. Historically, the yield curve is upward sloping meaning investors will require a higher yield to invest for a longer period. This is because of the time value of money: the longer you are willing to lend money, the more you would like in return. With the Fed's recent hiking cycle, the yield curve is currently inverted, so the highest yield is currently in the front end of the curve.

Another significant difference between equities and bonds, especially in corporates, is there is typically only one common stock, but a company can have dozens of bonds outstanding. An investor can also decide how much price volatility they are willing to take with the coupon with greater price changes occurring in a lower coupon versus more stability in a higher coupon. Issuers may even have distinct types of debt, such as senior and junior liens. The higher the seniority, the higher the bondholders claim on assets in the event of a default. This allows an investor to make several decisions such as a different coupon, credit risk, and maturity for the same issuer.

Credit risk is determined by the probability that the entity receiving the loan is not going to be able to repay its debt. For example, the default risk for U.S. Treasury borrowers is nil whereas high yield or junk sector issues have higher default risk, explaining their higher interest rates because of the risk/reward ratio. The default risk

is reflected by the credit rating, which can be thought of as a credit score for the bond market. Various sectors have different default risks and components affecting their credit quality. Outside of treasuries, the sector with one of the lowest default rates is the municipal market. Municipal credit analysis depends on numerous factors, such as whether a municipal bond is a general obligation bond, revenue bond, tax exempt, or if there's insurance (See our paper "[Municipal Bond Basics](#)"). Further, market values can be affected by changes in ratings even within the highly rated categories.

## Investing in the Fixed Income Market

A fixed income portfolio is built by first determining what you would like to invest in. Here at KAR, we have municipal portfolios, taxable portfolios that include corporates, agencies, treasuries, and taxable municipals, and we have cash management portfolios. When determining what type of bonds to build out your portfolio with, an investor needs to keep in mind their tax situation, interest rate expectations, time horizon, and liquidity requirements. For example, when analyzing liquidity needs, outside of U.S. Treasuries, bonds do not have robust liquidity. As for another example, we believe a factor that makes the municipal market attractive is that the income can be tax free at the federal, state, and even local level, which can be a significant source of tax-free income for those in higher tax brackets.

## Benefits and Disadvantages of Fixed Income Markets

In our view, the systematic income stream from bonds makes them an asset class to consider when putting together an investment strategy. This income can be particularly attractive to conservative investors or those



in need of regular cash flow, such as retirees. Bonds also have a defined maturity date and call dates, allowing investors to know when their principal will be repaid. This is important for individual bonds when interest rates have increased, as the bonds will naturally mature at par.

Bonds issued by the federal, state, or local governments or companies with high credit ratings are considered lower risk investments because of their position in the capital structure. In the event of default, bondholders have a higher claim on the issuer's assets compared to equity holders. This may provide an additional layer of reassurance, especially in times of economic uncertainty.

Since bonds are debt instruments, they do not trade exactly like equities. This can provide diversification, a key tool in a well-rounded investment portfolio. Bonds have lower correlation with other asset classes; therefore, performance typically does not move in sync with the stock market. By including bonds in a portfolio, investors may reduce their risk and volatility.

As with all investment decisions, there are some disadvantages. A potential drawback is if inflation erodes purchasing power over time. While bonds provide fixed

income, their returns may not keep pace with rising inflation, leading to a decrease in real purchasing power over time. Bond prices are sensitive to changes in interest rates because as interest rates rise, bond prices fall and vice versa, leading to changes in market value. Investors may be able to limit this risk by not going too far out on the yield curve—the more time built into a portfolio, the more volatility. Interest rate risk can result in losses if investors need to sell their bonds before maturity. Bonds do have default risk, especially for those issued by lower-rated entities or those facing financial difficulties. To limit this risk at KAR, we seek highly rated issuers or those that we believe have strong and improving credit characteristics to mitigate credit risk in our portfolios.

It is important to understand and gauge the advantages and disadvantages of fixed income markets before investing. Meeting with a wealth advisor who can review your portfolio, assess your current financial situation, and understand your goals for the future may help you decide if investing in bonds is right for you. To explore whether a fixed income security is the right approach for your portfolio, [contact a KAR advisor](#) for investment management and wealth advisory services.

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