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Investment Basics

Everything You Need to Know About Bonds: Bond Investment Strategies

Bond investors can choose from many different investment strategies, depending on the role or roles that bonds will play in their investment portfolios.

Passive investment strategies include buying and holding bonds until maturity and investing in bond funds or portfolios that track bond indexes. Passive approaches may suit investors seeking some of the traditional benefits of bonds, such as capital preservation, income and diversification, but they do not attempt to capitalize on the interest-rate, credit or market environment.

Active investment strategies, by contrast, try to outperform bond indexes, often by buying and selling bonds to take advantage of price movements. They have the potential to provide many or all of the benefits of bonds; however, to outperform indexes successfully over the long term, active investing requires the ability to form opinions on the economy, the direction of interest rates and/or the credit environment; trade bonds efficiently to express those views; and manage risk.

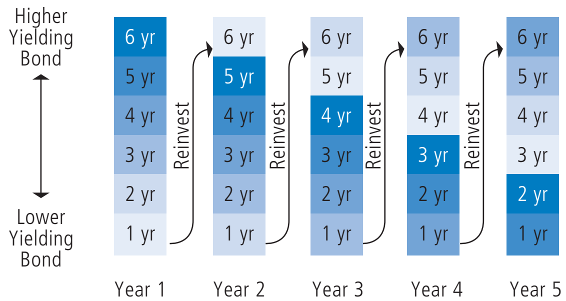
Passive Strategies: Buy-and-Hold Approaches

Investors seeking capital preservation, income and/or diversification may simply buy bonds and hold them until they mature.

The interest rate environment affects the prices buy-and-hold investors pay for bonds when they first invest and again when they need to reinvest their money at maturity. Strategies have evolved that can help buy-and-hold investors manage this inherent interest-rate risk. One of the most popular is the bond ladder. A laddered bond portfolio is invested equally in bonds maturing periodically, usually every year or every other year. As the bonds mature, money is reinvested to maintain the maturity ladder. Investors typically use the laddered approach to match a steady liability stream and to reduce the risk of having to reinvest a significant portion of their money in a low interest-rate environment.

Climbing the bond ladder

In a laddered portfolio, maturing short-term bonds are reinvested in bonds at the ladder's long end, which typically offers higher yields. That can be an advantage in a rising interest rate environment.



Source: PIMCO

Another buy-and-hold approach is the barbell, in which money is invested in a combination of short-term and long-term bonds; as the short-term bonds mature, investors can reinvest to take advantage of market opportunities while the long-term bonds provide attractive coupon rates.

Other Passive Strategies

Investors seeking the traditional benefits of bonds may also choose from passive investment strategies that attempt to match the performance of bond indexes. For example, a core bond portfolio in the U.S. might use a broad, investment-grade index, such as the Barclays Capital Aggregate Bond Index, as a performance benchmark, or guideline. Similar to equity indexes, bond indexes are transparent (the securities in it are known) and performance is updated and published daily.

Many exchange-traded funds (ETFs) and certain bond mutual funds invest in the same or similar securities held in bond indexes and thus closely track the indexes' performances. In these passive bond strategies, portfolio managers change the composition of their portfolios if and when the corresponding indexes change but do not generally make independent decisions on buying and selling bonds.

Active Strategies

Investors that aim to outperform bond indexes use actively managed bond strategies. Active portfolio managers can attempt to maximize income or capital (price) appreciation from bonds, or both. Many bond portfolios managed for institutional investors, many bond mutual funds and an increasing number of ETFs are actively managed.

One of the most widely used active approaches is known as total return investing, which uses a variety of strategies to maximize capital appreciation. Active bond portfolio managers seeking price appreciation try to buy undervalued bonds, hold them as they rise in price and then sell them before maturity to realize the profits – ideally "buying low and selling high." Active managers can employ a number of different techniques in an effort to find bonds that could rise in price.

- **Credit analysis:** Using fundamental, "bottom-up" credit analysis, active managers attempt to identify individual bonds that may rise in price due to an improvement in the credit standing of the issuer. Bond prices may increase, for example, when a company brings in new and better management.
- **Macroeconomic analysis:** Portfolio managers use top-down analysis to find bonds that will rise in price due to economic conditions, a favorable interest-rate environment or global growth patterns. For example, as the emerging markets have become greater drivers of global growth in recent years, many bonds from governments and corporate issuers in these countries have risen in price.
- **Sector rotation:** Based on their economic outlook, bond managers invest in certain sectors that have historically increased in price during a particular phase in the economic cycle and avoid those that have underperformed at that point. As the economic cycle turns, they sell bonds in one sector and buy in another.
- **Market analysis:** Portfolio managers can buy and sell bonds to take advantage of changes in supply and demand that cause price movements.

- **Duration management:** To express a view on and help manage the risk in interest-rate changes, portfolio managers can adjust the duration of their bond portfolios. Managers anticipating a rise in interest rates can attempt to protect bond portfolios from a negative price impact by shortening duration, possibly by selling some longer-term bonds and buying short-term bonds. Conversely, to maximize the positive impact of an expected drop in interest rates, active managers can lengthen duration on bond portfolios.
- **Yield curve positioning:** Active bond managers can adjust the maturity structure of a bond portfolio based on expected changes in the relationship between bonds with different maturities, a relationship illustrated by the "yield curve." While yields normally rise with maturity, this relationship can change, creating opportunities for active bond managers to position a portfolio in the area of the yield curve that is likely to perform the best in a given economic environment.
- **Roll down:** When short-term interest rates are lower then longer-term rates (known as a "normal" interest rate environment), a bond is valued at successively lower yields and higher prices as it approaches maturity or "rolls down the yield curve." A bond manager can hold a bond for a period of time as it appreciates in price and sell it before maturity to realize the gain. This strategy can continually add to total return in a normal interest rate environment.
- **Derivatives:** Bond managers can use futures, options and derivatives to express a wide range of views, from the creditworthiness of a particular issuer to the direction of interest rates.

An active bond manager may also take steps to maximize income without increasing risk significantly, perhaps by investing in some longer-term or slightly lower rated bonds, which carry higher coupons.

Active vs. Passive Strategies

Investors have long debated the merits of active management, such as total return investing, versus passive management and ladder/barbell strategies. A major contention in this debate is whether the bond market is too efficient to allow active managers to consistently outperform the market itself. An active bond manager, such as PIMCO, would counter this argument by noting that both size and flexibility help enable active managers to optimize short- and long-term trends in efforts to outperform the market. Active managers can also manage the interest-rate, credit and other potential risks in bond portfolios as market conditions change in an effort to protect investment returns.

A word about risk: Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not.

Duration is the measure of a bond's price sensitivity to interest rates and is expressed in years.

PIMCO advised funds are distributed by PIMCO Investments LLC.

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