PROSPERA
FINANCIAL SERVICES

FIXED INCOME INVESTMENT GUIDE

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The capital markets of 2022 will be remembered for a great many characteristics, perhaps none more so than the outcomes for fixed income markets.

A notable shift in domestic central bank monetary policy, reacting most notably to widespread inflationary evidence, directly brought dramatic changes in rates, and indirectly to anything they touched.

Rates vs Asset Values

The US Federal Reserve raised the fed-funds rate seven times in 2022, taking the overnight rate from 25 bps to 450 bps – a 15-year high. By contrast, the Bloomberg US Aggregate Bond Index fell 13% over the same period, only its 5th negative year on record since 1974, and by far its worst.

As the rates directly controlled by the US federal reserve changed in haste, so too did the behaviors and portfolios of institutional and retail investors.

Historic Bonds Fund Outflows

Fixed Income mutual funds experienced outflows of $541B in 2022, with net assets declining $1.1T (or 20%) over the same period. When combining asset flows of both ETFs and Mutual Funds, net redemptions in 2022 were the highest on record since 1992.

Bond Desks Shuttered

Some proprietary bond desks simply didn't survive 2022. Citigroup, most notably, shuttered its proprietary municipal bond trading unit amid trading losses and an exodus of personnel.

Still, as bond investors were put on guard by an asset class moving inverse to that of sharply rising rates, and lock-step with a declining equity market, the wake behind an overall market recalibration has in some ways created an avant-garde environment within some less, less-appreciated fixed income securities; stodgy old individual bonds.

While redemptions in bond funds were the highest on record, demand for individual bonds, and particularly tax-exempt municipal bonds, grew substantially as interest rates rose.

Municipal Bonds Find Buyers

A record number of municipal bond trades were recorded in 2022, exceeding the previous high watermark (2008) by 17%, and previous year levels by 66%. The par amount of fixed-rate municipal bonds traded last year was 22% higher than the previous record as well.

Some firms were forced to reduce resources behind their fixed income services; Prospera views the evolving landscape as one in which our firm and clients can truly offer substantial value within dislocated markets.

Rather than reduce services, we have **enhanced** them, believing this is an area that provides a differentiator **to our clients** in 2023, and beyond.

BOND 101:
KEY POINTS TO REMEMBER

The following are a few important reminders regarding nuances of bond markets.

A SPRAWLING MARKET

The US bond market is a $50T industry comprised of hundreds of thousands of issuers. The municipal market alone has 40,000+ issuers. Due to the sprawling nature of the landscape there is often not an active two-sided market for a bond, and many trade infrequently. A full service desk experienced in market-making can bid bonds on your behalf to greatly improve execution.

INVENTORY MATTERS

Bonds primarily trade over-the-counter, rather than on a centralized exchange. Investors looking to buy or sell bonds must go through dealers. Any single dealer's inventory can be a poor representation of value existing elsewhere in a decentralized market. A full-service desk has access to many dealer inventories, and actively bid these markets on your behalf or to establish firm inventory for later use when we see value in a credit.

EXECUTION YIELDS YIELD

Bid-ask spreads are greatly impacted by many aspects of a transaction, among them size. A direct route to increasing yield on a bond is improving execution. The average municipal bond trade below $25k of par value is transacted at a spread more than 100 bps wider than trades of $50k (or more). A dedicated fixed income desk can work actively to improve yield to the client via better execution.

CREDIT RESEARCH MATTERS

Credit ratings are often conflated with default risk, but an A+ rating for a corporate bond does not carry the same default risk as an equivalently rated municipal bond, in fact it is substantially higher. A deep understanding of the credit and any dedicated revenue stream behind it is key to durability.

DURATION RISK IS ONLY PART OF IT

Bond portfolio construction is often an exercise in marrying assets (capital) to liabilities (income needs) in an efficient manner. Duration risk is a factor, so too is the replacement risk of yield, as well as the tax equivalent yield along the duration curve. All play a role in driving the efficiency of that initial exercise. In 2022, yields for municipal bonds improved greatly versus treasuries on some parts of the curve, and not at all on others. A good team of bond traders will be well equipped to support an efficient portfolio design to help you meet client needs.

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Paul Keeton, Managing Director of Investments & Advisory Solutions, leads the development and execution of the firm's advisory program, product offerings, as well as equity and fixed income desks.

Admired for his deep expertise and experience in the industry, Paul is a graduate of the Virginia Military Institute with a degree in Civil Engineering and began his career in finance with Dorsey, Wright & Associates in 1997.

He's since shaped and driven Prospera's product platform and advisory offerings breadth – and helped our advisors find the most exacting client solutions.

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