Fixed Income:

Should I Stay or Should I Go?

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Veteran fixed-income investor Mark Vaselkiv of T. Rowe Price discusses the versatility and appeal of fixed income, even in a low- to negative-yield environment. Vaselkiv, a 30-year investment industry veteran, is manager of T. Rowe Price's High Yield Fund and institutional high-yield strategies, and co-manager of the T. Rowe Price Global High Income Bond Fund.

P&I: What are the macro factors that are buffeting fixed-income investments and investors today?

Mark Vaselkiv: Since the financial crisis, growth has taken a dramatic leg down. We see a couple of reasons for that. One is that there is a demographic trend at work where, in Europe, the U.S. and particularly Japan, populations are getting older, and as populations age, consumption declines. Productivity has also plummeted, and that's slowing growth. We also think that the significant amount of inequality in the global economy is a contributor.

Central banks have been trying to stimulate growth to make sure that we get out of this rut. When you think about central bank policy today, the G-10 countries [Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the U.K. and the U.S.] have issued about $34 trillion worth of sovereign debt. But about 35% of that carries a negative yield today, more than 70% is below 1%, and more than 90% is under 2%. It's so different from anything we have experienced in our lives in the fixed-income world. And those sovereign rates really set yields and valuations for all kinds of fixed-income securities.

The question is, can the Federal Reserve or the ECB (European Central Bank) or the Bank of Japan really do enough to push the needle higher on growth? We would argue that's not going to be the case. And that leads to the question of the efficacy of central bank policy, which is raising a whole host of issues, such as whether fiscal easing is the next step for some countries.

P&I: Can or should investors tune out those questions about monetary policy? What should they be focused on?

Vaselkiv: Risk-free bonds can serve as insurance policies in the event of a very serious geopolitical or economic problem in the world. Having some risk-free safe instruments, such as U.S. Treasuries or German bunds, provides a level of downside protection in a world where those types of anomalies occur with increasing frequency.

It's clear that investors are willing to hold onto those types of securities and even this year, notwithstanding the fact that rates have been very low, they've still delivered very positive returns. So amazingly, the German bund market has delivered more than 5% year-to-date, and even the five-year Swiss bond has generated positive total returns. So holding instruments able to perform in times of stress remains very important.

And I would also say, as a little bit of a corollary to that point, that central bank policy really has acted like a fire extinguisher during these periods of major volatility. I think the classic example of that would be this summer, when the Brexit vote took the whole world by surprise. Right after that, for the first two or three days, global financial markets lost trillions of dollars and there was a major anxiety attack going on pretty much everywhere. But the central banks stepped in quickly and their moves really put the fire out. The markets calmed down dramatically and we were back off to the races because of that expectation that the fire truck will always show up when something goes wrong.

And so yes, you can talk about negative yields, but if you think about those securities as insurance policies, there is a cost to owning any insurance policy.

P&I: Is that all that investors should count on? Ultimately, what should investors expect from fixed income? And how should they factor in those negative interest rates?

Vaselkiv: From an asset allocation perspective, clearly there is a need to have that type of insurance in an investment portfolio. In fact, if you're evaluating any type of investment strategy, there are five key considerations that one should think about, whether it's stocks, bonds, commodities or hedge funds: return, volatility, liquidity, time horizon and correlation.

Return is not looking good right now. With rates this low, the potential of long-term performance is growing more challenging. The volatility of short-term government bonds is much lower than it is for stocks and other riskier instruments. Liquidity is good in parts of fixed income; you have typically many of these risk-free securities you can buy and sell in big blocks, and that's important. But the correlation factor is really critical. You should own some assets that will move in a different direction when most of the world markets are going to hell in a handbasket.

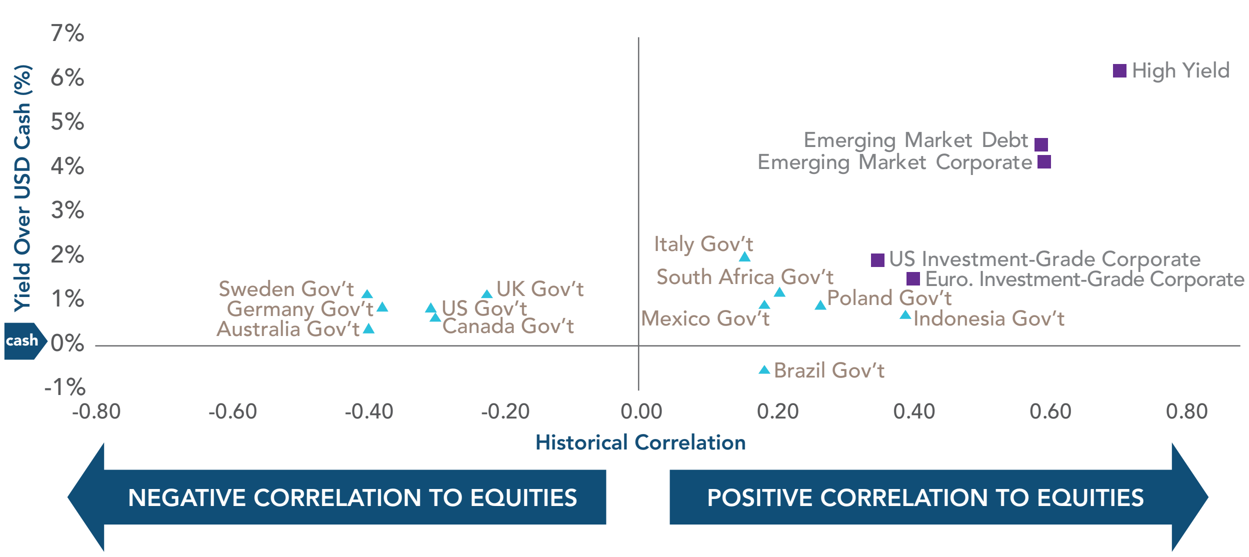
P&I: How should investors adjust their portfolios to be prepared for a Fed hike?

Vaselkiv: I think looking at floating-rate strategies like

ULTIMATELY, WHAT DO WE REALLY EXPECT FROM FIXED INCOME?

as of September 30, 2016

CURRENT YIELD ABOVE USD CASH VS. HISTORICAL CORRELATION
Last 10 Years



Past performance is not a reliable indicator of future performance.
Sources: UBS, Barclays, J.P. Morgan, Bank of America/Merrill Lynch, S&P, MSCI, and T. Rowe Price. Yield shown is on a hedged basis in US dollars. Volatility is based on the monthly returns each asset class hedged into US dollars.

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bank loans is a really prudent way of doing that. And I think also perhaps moving a portion of an investor's allocation to cash is not a terrible alternative in this environment, particularly with negative yields. You need to be willing to add to global fixed-income allocations after the inevitable disruptions that we're going to experience over an extended period of time. By dollar-cost averaging as rates normalize up, and thinking about a program where you're adding risk assets as well as risk-free assets over an extended period of time has generally proven to be a very profitable way of investing.

An additional way to prepare portfolios for the risk of a Fed hike is to look at duration. This is an area where good unconstrained managers can implement various tools including shorter-duration concepts, to bring down the interest-rate risk of a portfolio.

P&I: What are the risks in unconstrained approaches that investors need to be aware of?

Vaselkiv: You need to consider whether the investment principles of these unconstrained strategies can really stand the test of time and fit your own objectives. The sustainability issue is really important, particularly for long-term investment horizons. What will those strategies deliver in performance over 10, 15, 20 years and will they be true to their core objectives? Ultimately they demand a degree of flexibility in making significant portfolio shifts, and that takes a high degree of skill among managers.

Over the last five years, we, as fixed-income managers, have had tremendous tailwinds at our back. We've been in a positive credit cycle. The economic cycle has been strong for corporate strategies such as high yield. It's been a great period, and since the financial crisis, we really haven't experienced a lot of default risk or a financial stress. Interest rates have been falling, and that's a massive benefit for any type of fixed-income investor.

There's been a lot of deleveraging, and that's generally a very positive sign for owning bonds. So those three tailwinds have been terrific. But over the next two to three years, as interest rates begin to normalize, it's going to be tougher for more traditional strategies.

So yes, this has really been a great, great environment for fixed income on many different levels, but we're moving into new parts of the cycle. It's going to be a lot tougher. The real challenge is casting that net as wide as possible. It really takes a global approach to be able to execute and accomplish that.

P&I: There are ways to create equity-like investments using fixed-income instruments. Is that something that plan sponsors should be considering?

Vaselkiv: I think you can do it to a degree. I have a strong belief that careful security selection in below investment grade credit strategies can provide equity-like returns with less risk and have proven sustainable over multiple credit cycles for over 25 years.

Further, derivatives can be used in tandem to enhance return potential. We have selectively used derivatives to express strong credit opinions and to amplify some of the best bets that we have made over time. Derivatives usage for unconstrained fixed-income strategies are a prevalent part of their arsenal. It is much tougher to consistently execute. If you are managing a long-short fixed income strategy where you need to go in both directions, derivatives are just one tool among many in the kit that can be employed effectively.

P&I: Is it the new normal that fixed-income investors will have to continue to cast such a wide net?

Vaselkiv: Yes, absolutely. For example, one of the big challenges of leading the high-yield market strategy in the firm is that it tends to often become a very crowded trade. Everybody's piling into U.S. high yield because it's perceived as being the strongest, largest, deepest economy in the world. So if you buy a U.S. double-B-rated high-yield bond, you're going to earn around 4.5% in today's world. That's not particularly compelling. But maybe you can find the double-B-rated Australian steel company that's yielding 7%. It's a great credit, but it takes some work to uncover it. You need a globally deployed team that understands the Australian steel industry and the macroeconomic drivers influencing the global steel industry. Not everybody can pull that off.

The wider net allows you to move away from crowded trades. We like to say there are two types of investors, permanent residents and tourists. Right now in the high-yield market, tourists are looking for yield. Residents have the potential to find the undiscovered island on the globe. By looking at a more global investment set, we believe we are positioned to take advantage of the best long-term opportunities for our clients.

P&I: We've discussed a number of interesting fixed income factors. What is your take-away for investors?

Vaselkiv: There are two key themes. The first is that you should look more globally, casting the wider net, as various markets provide different risk and return opportunities. Second, as you move more globally, selectivity in these markets becomes more paramount. This means you need globally dedicated resources to be active and creative to source the most optimal value in fixed income markets. ❖

ABOUT T. ROWE PRICE

as of September 30, 2016

Founded in
1937

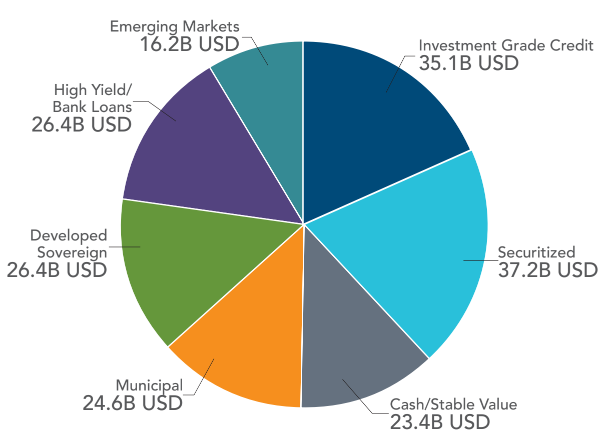
Locations in
16
countries

Over
6,000
associates worldwide

812.9 Billion USD[1]
assets under management

BREADTH AND DEPTH IN EVERY MAJOR GLOBAL FIXED INCOME SECTOR

189.3 Billion USD in Fixed Income AUM[2]
as of September 30, 2016

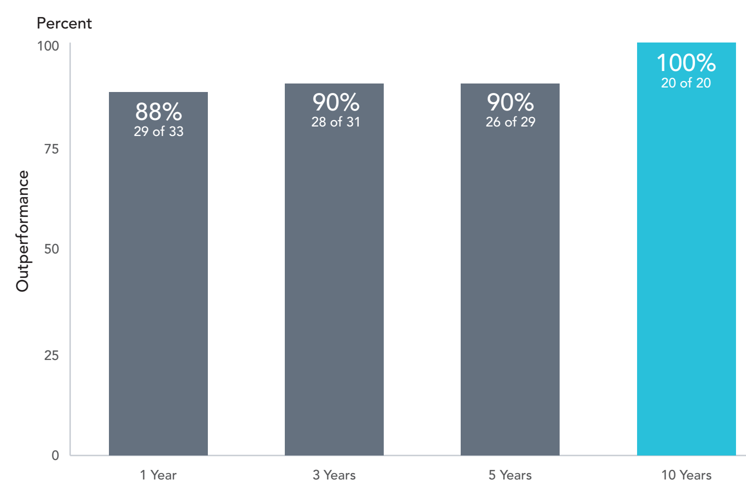


[1] *The combined assets under management of the T. Rowe Price group of companies. The T. Rowe Price group of companies includes T. Rowe Price Associates, Inc., T. Rowe Price International Ltd., T. Rowe Price Hong Kong Ltd., T. Rowe Price Singapore Private Ltd., and T. Rowe Price (Canada), Inc.*

[2] *Total fixed income assets include all fixed income separate accounts and funds, along with a portion of certain T. Rowe Price U.S.-registered asset allocation funds. Numbers may not add due to rounding.*

OUR ACTIVE APPROACH LED TO CONSISTENT LONG-TERM RESULTS

100% of our fixed income composites beat their benchmarks over 10 years[1]



Past performance cannot guarantee future results
[1]*Performance as of September 30, 2016; marketed fixed income composites with more than 100 million USD in composite assets with a relevant Mercer, Russell, or Callan Universe. Rankings based on (gross) returns. Returns would have been lower as the result of the deduction of applicable fees. This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are as of October 2016 and are subject to change. Investment advisory services provided by T. Rowe Price Associates, Inc.*

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