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Bonds Are Back. Here Are the Income-Generating Funds to Buy Now.

BY DEBBIE CARLSON

Things are looking up for bonds. They finally get to act like bonds again, behaving as a ballast against stock market volatility and a reliable income producer.

"It's nice to have them back, because they were gone for the longest time," says Jeff Winn, a managing partner at International Asset Advisory, a financial advisory firm.

The asset class just suffered one of its worst years in decades, with the Bloomberg U.S. Aggregate Bond Index losing 15% in 2022 as the Federal Reserve aggressively hiked interest rates seven times to tame the highest inflation rates in 40 years. Stocks also suffered, with the S&P 500's total return down 18%.

Those hikes pushed the federal-funds rate range to 4.25% -4.5%, and the Fed isn't done yet. Chairman Jerome Powell has signaled that rate increases will continue into 2023, although not at 2022's blistering pace, as inflation appears to be subsiding.

After bonds' dismal year, fixed-income strategists and financial advisors say now is a good time to reintroduce them to portfolios. Since the Fed isn't done and there's a chance of a recession in 2023, they advise investors to stay in the short-to-intermediate end of the yield curve, buy high-quality credits that are likely to withstand a recession, and avoid reaching for yield.

"You can make money owning high-quality bonds again, and that's a nice change for all the savers out there compared to the past decade," says Bill Merz, head of capital markets research at U.S. Bank Wealth Management.

Here are top strategists' views on fixed-income sectors and financial advisors' fund ideas of how to play it as the new year begins.

THE YEAR OF FIXED INCOME

Recession risks aside, 2023 could be the year fixed income is a better bet than stocks. Pramod Atluri, principal investment officer of American Funds' $72.5 billion Bond Fund of America (ticker: ABNDX), a core bond mutual fund, expects inflation to continue falling and the U. S. economy to see either very weak growth or a mild recession, while Europe suffers a deeper slowdown. He predicts China will get a tailwind from its Covid reopening.

"If you have falling inflation and a lower growth environment, that' s kind of perfect for fixed income," Atluri says. "That's almost the best possible scenario."

Bonds compare favorably with stocks, says Anders Persson, head of global fixed income at Nuveen. "Fixed income is offering very attractive income opportunity, yield opportunity, and relative value opportunity, as well, compared to equities," he says.

Both Atluri and Persson believe Powell & Co. may be closer to the end of their rate-hiking cycle than the beginning, assuming inflation continues to subside. If rates peak, investors should move out of cash, one of 2022's best-performing asset classes, and start buying high-quality, diversified bond funds with duration between five to eight years out, they advise. (Duration measures bonds' price sensitivity to changes in interest rates.)

The first quarter still holds plenty of unknowns, Merz says, and as long as the trend of weaker stocks and rising yields persists, there's no reason to buy long-dated bond funds.

If investors buy just one bond fund, they should consider a core bond fund with a duration similar to the benchmark Bloomberg U.S. Aggregate Bond Index, about six years. Investors can keep it simple and pick up a diversified index-based fund such as the Vanguard Total Bond Market exchange-traded fund (BND) or the iShares Core U.S. Aggregate Bond ETF (AGG), says Don Bennyhoff, chief investment officer at Liberty Wealth Advisors, who uses these ETFs in his clients' portfolios.

Both ETFs have expense ratios of 0.03%, an average yield to maturity of around 4.5%, and an effective duration of about 6.5 years. The Vanguard fund has about 50% of its holdings in U.S. government debt, 26% in corporate debt, and 21% in securitized debt, while the iShares

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fund has 45% in U.S. government debt and 25% each in securitized and corporate debt.

For investors who want managers able to change tack in response to economic conditions, active ETFs are another inexpensive option. One of the core ETFs that Matt Pierce, portfolio manager at Austin Wealth Management, uses is Dimensional Core Fixed Income (DFCF), an investment-grade fund comprised of 76% AAA-rated bonds, split between 46.5% U.S. government and 53% corporate bonds. It has a modified duration of 6.6 years, a yield to maturity of 5.5%, and an annual fee of 0.19%.

The fund tracks the bond benchmark fairly closely, but Dimensional also adds a factor tilt that allows the fund to go up or down in credit quality depending on economic conditions. "It's still very benchmarky, but not a pure passive approach to the core portfolio," Pierce says.

Bond ETFs have become popular with financial advisors for their lower cost and tax efficiency, and because they can be used strategically and tactically. They are beginning to muscle out mutual funds, just as they did in equities. Todd Sohn, ETF strategist at Strategas, says the bond bear market accelerated the shift, noting that over the past 12 months, a record $634 billion has moved from bond mutual funds into ETFs.

Derek Amey, co-chief investment officer at StrategicPoint Investment Advisors, is custom-building a core-bond approach using ETFs, concerned the Fed's tightening will trigger a harder recession. Separately, he owns U.S. Treasuries and corporate bond ETFs to mimic a single core or core-plus fund, freeing him to react quickly to changes in economic conditions.

Some of his building-block ETFs include iShares 1-3 Year Treasury Bond (SHY); SPDR Portfolio Intermediate Term Treasury (SPTI), which owns U.S. Treasuries with a maturity between three to 10 years; and Vanguard Short-Term Corporate Bond (VCSH), which holds investment-grade bonds with maturities between one to five years.

By breaking up the Treasury and corporate exposure, Amey says he can sell the corporate ETFs if a recession is harder than expected, but keep the Treasury ETFs, which may benefit from a flight to quality by investors.

CONSIDER YOUR RISK EXPOSURE

In a 2021 Barron's interview, American Funds' Atluri predicted inflation would be higher and persist longer than others expected at the time. For 2023, he says if the Fed's rate tightening peaks by spring and if inflation continues to fall, the Fed can rein in monetary policy. It will remain restrictive, but if inflation falls enough, the Fed might be able to trim rates to rest just above the rate of inflation, leading to positive real rates.

If interest rates can stay above the inflation rate, that would support investment-grade corporate bonds and riskier assets such as high-yield bonds. The risk is if inflation doesn't continue to slide or if there's some other shock. Atluri adds that it isn't clear how much the market is currently pricing in a recession, making it still risky to buy lower-quality bond funds for more yield. Instead, he thinks a safer play is to extend duration, as he expects the Fed rate hikes will be finished by the middle of the second quarter.

Daniel Milan, managing partner of Cornerstone Financial Services, is dedicating only 15% of his bond allocation to corporates and is using the iShares 0-5 Year Investment Grade Corporate Bond ETF (SLQD) for a small yield bump. It has a yield to maturity of 5.1% and costs 0.06% annually.

Others doubt the Fed will pivot early. Daniel Morris, chief market strategist at BNP Paribas Asset Management, says his firm remains hesitant to extend duration, noting the bank's fixed-income portfolio duration is five years. Investors are too optimistic that inflation will fall fast and prompt the Fed to cut rates sooner.

"We think both of those assumptions are wrong. Powell has been trying to say that that's what the dot plot shows, and they just don't want to listen," Morris says.

Persson predicts the Fed will remain cautious. Still, he thinks high-quality corporate credit has a place in bond portfolios. One of his top ideas for 2023 is to own preferreds—hybrid securities that are part stock and part bond.

Most preferred issuers are banks and financial companies. Persson is "very comfortable" with their fundamental position and outlook since these institutions now have higher capital ratios and other regulatory oversight. He says the credit quality for many of these firms is single A, although with preferred securities, the buyers are lower on the capital structure if there are defaults.

Winn is also using preferred securities as part of his fixed-income allocation, in addition to passive core bond funds and some active nontraditional mutual funds. Right now he's only at about half the full bond allocation of a traditional 60/40 stocks/bonds portfolio, up from zero.

He uses the iShares Preferred & Income Securities ETF (PFF), which has a 6.12% SEC yield and costs 0.45% annually, and the more conservative Principal Spectrum Preferred & Capital Securities Income fund (PPSIX). It costs 0.79% and has a 12-month yield of 5.5%.

Another stock/bond hybrid option is an investment-grade convertible corporate bond fund, says Amy Bush, chief investment officer at Tandem Wealth Advisors. She uses Victory Incore Investment Grade Convertible (SBFMX), which has an 8.9% yield and a 1.1% expense ratio. Convertible bonds can be converted into common stock, and the Victory fund must hold at least 80% investment-grade companies. She calls it one of the most conservative

convertible funds available.

"They rise at an increasing rate as their underlying stock goes up, but they fall at a decreasing rate as they find their bond floor," Bush explains. "That's when convertibles shine—during downturns."

MUNI BONDS LOOK UNDERPRICED

Investors with taxable accounts and those who live in high-tax states may want to consider adding municipal bond funds, as the sector offers some unique opportunities, Merz says.

Muni funds suffered outflows last year, as performance suffered along with other bond categories. Many mutual fund managers sold their most-liquid holdings, which also happened to be their highest-quality assets, to meet redemptions, he says. That makes sense from a fund manager's perspective, but it also pushed valuations in high-quality munis to attractive levels relative to other credit strategies.

Tom Graff, head of investments at Facet Wealth, is using the iShares National Muni Bond ETF (MUB) in taxable accounts as a simple, inexpensive way to get diversified exposure. It charges an annual fee of 0.07% and has an effective duration of 6.3 years and a 3.6% yield to maturity.

In addition to offering tax-free yield, Graff says, this sector could appreciate when the Fed finally pivots. He prefers broadly diversified funds since the impact of any potential defaults would be limited, unlike smaller, concentrated active funds.

Pierce uses the actively managed Dimensional National Municipal Bond ETF (DFNM) to complement the Dimensional core bond ETF. The fund tracks its benchmark index closely, but the managers can tweak holdings as needed for additional return. The fund costs 0.18% annually, and has a modified duration of 3.5 years and a 3.5% yield to maturity.

Brian James, director of investments at Ullmann Wealth Partners, favors the actively managed BlackRock National Municipal (MDNLX) as a core muni fund, citing the managers' deep expertise. It costs 0.71% annually and has a yield to maturity of 4.9%, with an effective duration of 9.2 years. It's a highly diversified, high-quality investment-grade muni fund.

Bonds may experience near-term gyrations, but people in higher tax brackets should move to lock in yield with a diversified muni bond fund, Merz says. The tax-free yield "is an extraordinarily valuable feature that's hard to find elsewhere in the markets," he says.

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