Fixed Income Investing

One aspect of fixed income's role in a portfolio is to reduce volatility.

This may be accomplished by employing:

- Shorter maturities with lower equity correlations.
- High-quality issues such as US bonds.

In 1958, James Tobin's research proposed that the main purpose of fixed income was to temper the risk of equities. His "Separation Theorem" shifted focus from security selection to portfolio structure, and earned him the Nobel Prize in Economics in 1981.

One role of fixed income could be to reduce the volatility (i.e., standard deviation) of equities in a balanced portfolio. In order to do this, fixed income strategies may:

- Reduce maturity risk by holding shorter-term instruments of varying durations.
- Reduce default risk by holding high-quality obligations.
- Reduce currency risk through hedging.

This enables fixed income to serve its purpose in the overall portfolio without subjecting investors to unnecessary risk.

Fixed income active managers may attempt to predict future bond prices or yields. However, the current yield curve is the best reflection of the latest information. A variable maturity approach would shorten maturities in inverted yield curves, and extend them in upwardly sloped curves.

Upwardly sloped yield curves occur when shorter maturities have lower yields than longer maturities. In an inverted curve, shorter maturities have higher yields. A fixed income allocation is well served by concentrating its maturities in those that have the highest yields, and changing its maturity concentration as the yield curve changes.