FundX
INVESTOR GUIDE

Fixed Income Guide
to Navigating Changing Bond Markets

FUND INTELLIGENCE
Institutional Asset Management Awards 2017
FundX: Top Fixed Income Manager
Among 4 other shortlist finalists, sub$1 billon plans

How to survive and thrive as interest rates change

Investors who want to preserve their capital or reduce volatility in their portfolios have usually turned to bonds. With interest rates changing, however, some investors wonder if bonds can continue to provide the stability they're looking

In this guide, you'll learn:

- Why own bonds?
- How to choose between bond funds and individual bonds
- The advantage of bond funds when markets change
- Three factors to consider when investing in bond funds
- How to navigate changing bond markets
- What to do with high-yield bonds

WHO NEEDS BONDS? Probably You.

Most people still need to own bonds, whether interest rates are rising or falling. Even though bonds have historically gained less than stocks, they can play a crucial role in your investment success.

Here are three ways bonds can help you move forward:

1. Manage risk

Stock markets are volatile, and bonds remain your best defense. Bonds typically don't move in tandem with stocks. They can rise when stocks fall, as we saw in 2008, and those gains can provide an important buffer that helps you preserve your capital. Cash doesn't cut it: it doesn't yield enough to offer as much of a cushion in down markets.

2. Avoid emotional mistakes

Stock market declines can also take an emotional toll. You're more apt to panic when markets fall and take action based on fear, and this can really hurt your returns. Because bonds can provide some stability in turbulent markets, they can help you stay on track and avoid letting emotions lead you astray.

3. Add to your returns

When rates rise, bond prices typically fall, but there may still be opportunities for gains. Some bonds tend to hold up better than others when rates rise. High yield bonds, for instance, may do well if rates increase gradually because their higher yields can help compensate for falling bond prices. Global bonds may behave differently than U.S. bonds. U.S. interest rates may be rising as rates in other countries may be falling.

Dividends can also improve your results. Remember that your investment gains are total returns, which include the change in price as well as any distributions of capital gains or income dividends, and dividends from bonds could offset lower prices. And, as rates rise, bond fund managers roll maturing bonds into new bonds with higher yields.

BOND FUNDS or Individual Bonds?

You can invest in bond funds, which give you exposure to a portfolio of individual bonds, or you can build your own portfolio of individual bonds. We believe you are much better off with bond funds, particularly when markets change.

	Bond Funds		Individual Bonds	
Diversification	High	Funds give investors exposure to 1000s of individual bonds for a relatively low minimum investment ($1,000)	Low	A small investment in an individual bond is $25,000, so most investors would likely only own 4-10 individual bonds.
Liquidity Ability to move on if markets change	High	Can be sold at any time and in any market condition	Low	Can be costly and time-consuming to sell, especially in volatile markets.
Trading costs	Low	Funds trade at their net asset value and many funds are available without transaction fees (NTF).	High	Bonds trade at the market and spreads can be wide. Your selling price can be 1%-6% less than the bond's stated value.
Research teams to evaluate a company's creditworthiness	Yes	Larger funds may even negotiate for more favorable status with bond issuers.	No	If you invest in a bond that defaults, you could be left with pennies on the dollar.
Investment opportunities	Unlimited	Access to just about every area of the bond market, including floating rate, high-yield, world and emerging market bonds.	Limited	Typically limited to U.S. high-quality, low duration bonds.

WHY INVEST IN BOND FUNDS
Three Real-World Examples

2001: Mitigating default risk

Most funds own hundreds, if not thousands, of bonds, so if one bond defaults, the other positions can help offset losses. For instance, many funds held Enron, when it declared bankruptcy in 2001, and they still posted gains that year, thanks to their many other positions. Individual investors who planned to hold Enron debt to maturity learned the hard way that not every bond matures.

Don't assume you can rely on rating agencies like Moody or Standard and Poor's. Enron's bonds were rated investment grade until just days before it went bankrupt, and in the 2008 financial crisis, many previously top-graded companies lost their triple A ratings. Many funds have their own research teams devoted to evaluating each company's creditworthiness before purchasing bonds.

2008: Adapting to changing markets

What if you don't want to hold a bond to maturity? What if you need access to some cash or what if markets change and you want to quickly adjust your portfolio, like in the 2008 financial crisis?

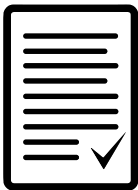
In 2008, some areas of the bond market lost 30% or more in a matter of weeks. If you'd held bond funds, you could sell at any time and in just about any market condition and get that fund's next closing price (NAV). Individual bonds, however, are harder and more expensive to sell, and you'd likely sell at a lower price than you expected. Your selling price could be 1 to 2% less than the bond's stated value. We've seen some bonds that sold for 5 to 6% less. And the spread can become wider during a crisis.

2016: Capitalizing on opportunities as interest rates rise

When you're buying individual bonds, you're typically limited to bonds that don't require deep research or professional expertise, like high-quality, low-duration U.S. bonds, but these bonds aren't always the best performers.

When interest rates rose in 2016, high yields, bank loans (floating-rate securities), and world bonds were some of the best performers. Buying individual bank loans, high-yield bonds or emerging market bonds can be both risky and costly. With funds, however, you can easily add exposure to these areas in diversified portfolios with many holdings, which have been vetted by experts in these specialized areas. Sometimes it just pays to hire a professional.

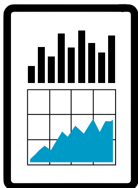
HOW TO SELECT Bond Funds



Step 1: Consider a wide range of bond funds

Don't limit yourself to just one area of the bond market. Instead, seek out opportunities from corporate and government bonds, higher and lower quality bonds and global and domestic funds.

Some funds typically hold up better than others, even in challenging markets, and investors who are open to many different funds are more apt to find a safe haven.



Step 2: Think about risks

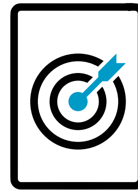
Not all bond funds have the same level of volatility, so you'll want to think about risks. Two common fixed income risks are credit risk and interest-rate risk.

Credit (or default) risk is the likelihood that an issuer will default on its obligations. Government bonds funds, which invest in securities issued by the U.S. Treasury and government sponsored agencies, pose minimal or no credit risk.

High-yield bonds, on the other hand, are issued by companies with questionable credit-worthiness and have higher credit (or default) risk.

Interest-rate risk: Bond prices are directly affected by changes in interest rates. Bond prices typically fall when rates rise, and prices increase when rates decrease, but some funds are more sensitive to changing interest rates than others.

Duration is a measure of interest-rate risk. Short-term bonds, for instance, have less interest rate risk than longer-term bonds.



Step 3: Focus on total return (not just yield)

Pay attention to a fund's total returns, which includes changes in the fund's price as well as the income the fund has generated.

Some investors consider only a fund's yield, the amount of income a fund generates as a percentage of the fund's current price. But a fund with a high dividend yield could still have a low or even negative total return, if its price has declined more than the income it has generated.

Higher-yielding funds also may have higher risks. They may invest in low credit quality bonds, which means a higher risk that some of its bonds could default. Or these funds could own longer-term bonds, which have higher interest-rate risk.

NAVIGATING
Changing Bond Markets

How can you know which bond funds to own now, especially when rising interest rates could really affect the bond market?

We've been navigating changing bond markets for decades, and one thing we've learned over the years is that a disciplined strategy can help you decide what kinds of bond funds to own now and when to move on to other funds.

A solid rules-based strategy gives you a way to:

- Determine when to own more conservative funds, like short-term funds.
- Mitigate the risk of high-yield and floating-rate funds.
- Adapt to changing bond markets in a disciplined way.
- Avoid emotional mistakes.
- Stay on track through a wide range of market environments.

Our Flexible Income strategy is designed to help you make these important decisions, and it has a proven track record of navigating changing bond markets.

The 2008 credit crisis was the steepest bond market decline in recent history. Our Flexible Income strategy led us to own lower-risk short-term government bonds, which helped us avoid the steep losses from high-yield bonds.

2008
Credit Crisis

We didn't stay in low returning short-term bonds indefinitely. When the bond market recovered in 2009, we bought back into high-yield, strategic and world bond funds that had strong returns.

2009
Market Recovery

When rates rose in 2016 and 2018, we focused on the funds that were excelling in the current market, like high-yield, floating-rate and strategic bond funds. We also avoided more interest-rate-sensitive bonds like Treasuries and long-term bonds.

2016-2018
Rising Interest Rates

CASE STUDY:
High-Yield Bond Funds

Lower-quality bonds, like high yields, can add tremendous value at times, so it makes sense to at least consider investing in them. In 2016, for instance, they outpaced both stocks and higher quality bonds.

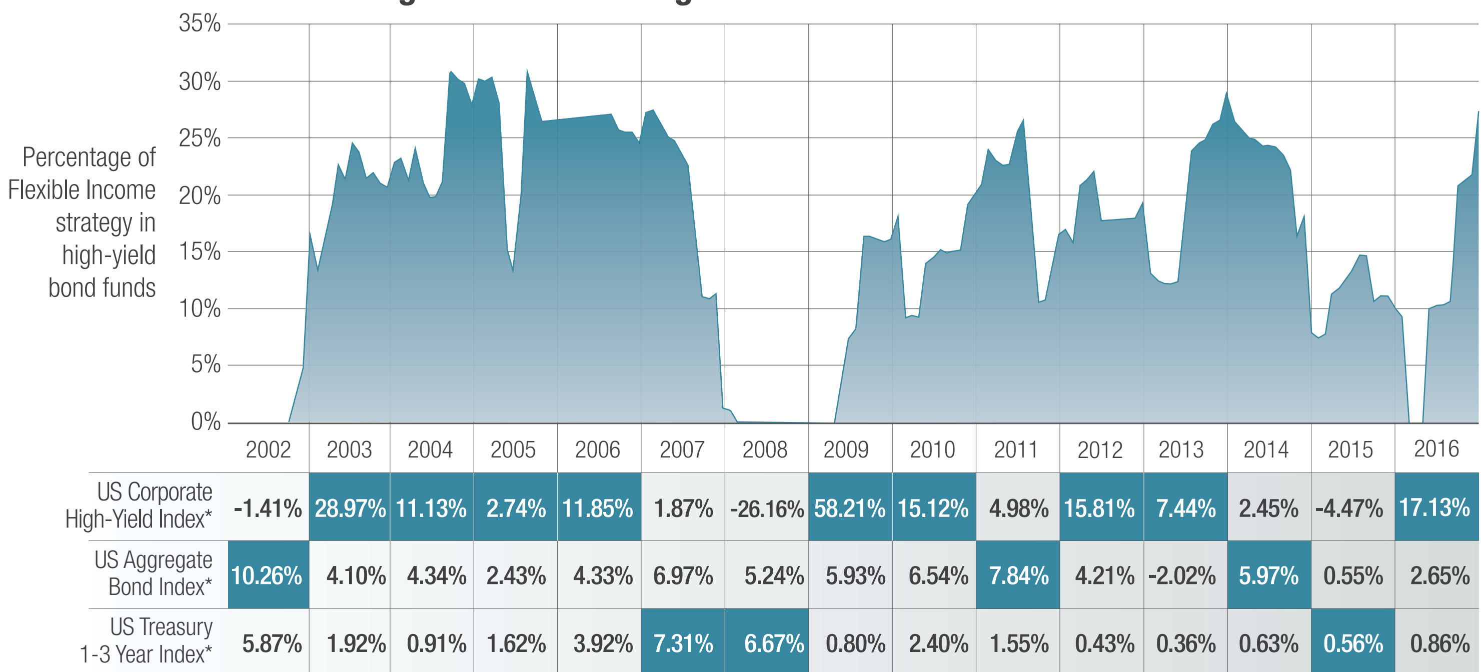
They can also be useful in a rising interest-rate environment since their higher dividend yields could help offset a decline in bond prices.

You need to use high-yield bonds carefully, however, because these funds are risky. These are lower credit quality ("junk") bonds, so they have a higher risk of default, and defaults tend to increase during times of economic stress.

High-yield bonds also can be quite volatile compared to other bonds. They are typically more correlated to stock markets, and that can make it hard for investors to hold these bonds long term. During the 2008 credit crisis, some high yield bonds lost 20-30%.

When to own (and when not to own) high-yield bonds

The FundX Flexible Income strategy offers a useful case study for investing in high-yield bond funds. It has a 15-year track record of moving us into high yields when they have strong recent returns and steering clear of these bonds when they've lost momentum, as you can see in the chart below.



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
US Corporate High-Yield Index*	-1.41%	28.97%	11.13%	2.74%	11.85%	1.87%	-26.16%	58.21%	15.12%	4.98%	15.81%	7.44%	2.45%	-4.47%	17.13%
US Aggregate Bond Index*	10.26%	4.10%	4.34%	2.43%	4.33%	6.97%	5.24%	5.93%	6.54%	7.84%	4.21%	-2.02%	5.97%	0.55%	2.65%
US Treasury 1-3 Year Index*	5.87%	1.92%	0.91%	1.62%	3.92%	7.31%	6.67%	0.80%	2.40%	1.55%	0.43%	0.36%	0.63%	0.56%	0.86%

*All indexes cited are Bloomberg Barclays indexes

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PUT FLEXIBLE INCOME
to Work in Your Portfolio

The Flexible Income approach shows that you don't need to predict what will happen in future in order to know which bond funds to own today. What you do need is a time-tested plan that can help you know where to invest now and what to do when markets inevitably change.

Our award-winning Flexible Income approach to bond investing has helped thousands of investors

- Own a diversified portfolio of bond funds
- Use higher- and lower-quality bonds effectively
- Adapt to changing bond markets, including periods of rising interest rates

Learn more about how you can use the Flexible Income approach, call FundX at 1-800-763-8639 and ask to speak with an advisor.

How to Invest in Flexible Income

This strategy was initially only available to our private money management clients. Today we share this approach with members of our NoLoad FundX newsletter, and we also implement this strategy for shareholders of the mutual funds we manage. Through the funds, you can invest in this approach with as little as $1,000.

About FundX

FundX Investment Group has built and managed fund portfolios for high-net-worth clients and foundations since 1969. The firm's time-tested evidence-based, global investment strategies have helped thousands of investors build wealth, navigate changing markets, and meet lifelong investment goals.

FundX
because markets CHANGE