

# INSIGHTS

## INVESTMENT



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## Rising Rates Present Opportunity for Institutional Investors

As the Federal Reserve continues to raise interest rates, some institutional investors are worried that those rising rates could represent a growing portfolio risk, creating a negative impact on their fixed-income returns.

Not everyone shares those concerns. While there are some challenges in the current environment, rising rates are a constructive trend for fixed-income investors over the long term, according to Janelle Woodward, global head of fixed income at BMO Global Asset Management.

“When we look at how far we’ve come and where yields are now, we actually think it’s a good time to be investing in fixed income,” she said. “There is opportunity in many ways for people to derisk the fixed-income portion of their portfolio and still meet their return assumptions.”

She pointed out that the return to “normal” rates is happening at a slow pace, even with the acceleration in 2018. The Fed has increased rates eight times over three years in this cycle, and is likely to raise them once more before year’s end. While rates remain low by historic standards, Woodward said she believes the Fed is about two-thirds of the way into the normalization process. In her view, the key is in managing this transition as yields move higher and the asset class becomes more attractive.

Looking at rates in that context presents opportunity for some strategic fixed-income investors to take on less risk while also increasing portfolio diversification and liquidity by looking at multiple factors to create a fixed-income strategy.

### THE ART OF PREDICTION

Woodward said historically it’s been difficult to predict the exact trajectory of interest rates, and getting such predictions wrong could prove a costly mistake. So rather than make an absolute call in terms of interest rates, BMO has been thoughtful about positioning for changes in the shape of the yield curve and portfolio composition.

“Thinking about allocation from both the top down and the bottom up creates the right perspective and flexibility to weather the longer-term environments of fixed income,” she said.

While Woodward is keeping a close eye on inflation, especially rising wages and the flow-through of commodity costs, there are structural factors, such as the aging population and deflationary trends from technology, that temper

her concerns about an inflation surge, she said, adding that maintaining inflation levels close to 2% could be good for investors.

In addition to watching inflation, Woodward is keeping an eye on the overall U.S. economy. She sees the tax reform of 2017 and recent corporate earnings as tailwinds of growth. Lower corporate taxes helped push corporate profits up nearly 25% among S&P 500 companies in the second quarter, marking the second-largest year-over-year increase since 2010.

Woodward sees some opportunity in international investments too. “We’re fairly constructive on Mexico now, given what we’ve seen in terms of trade caps and the new trade agreement between the U.S., Mexico and Canada,” she said. “There are also some emerging market corporates that we think could add attractive diversification and yields within the context of broader portfolios.”

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Still, uncertainty remains around tariffs and overall trade policy; and even though companies exceeded forecasts, there was some hesitancy in closing guidance ranges during the most recent earnings season. That’s why Woodward is carefully watching business spending as one of the metrics that could become a leading indicator of an economic softening or slowdown.

For now, as stocks remain at or near record highs, Woodward said more institutional investors are thinking about

other asset classes and rebalancing.

“From an investor’s standpoint, the questions are about rebalancing, to better align to a strategic asset allocation, and considering whether the right mix of investments is within the portfolio,” Woodward said. “Given the run-up in stocks and equity valuations, investors are becoming more thoughtful about looking at other asset classes.”

### DEFENSIVE STRATEGIES

Many institutional investors have already started putting defensive strategies in place within their portfolios to prepare for rising rates. Those who are most successful have set a target asset allocation or strategic allocation that they are able to stick to, even during periods of volatility, Woodward said.

Having fixed income as a core part of a portfolio allocation remains an important part of a balanced portfolio, but having the right management is crucial.

“It’s prudent to have exposure to managers that have the flexibility to manage the current environment in terms of being nimble, being able to diversify and being able to capture alpha opportunities beyond just the high-level characteristics of a fixed-income universe,” Woodward said. “We think having that experience and flexibility to navigate the environment will continue to be important.”

That means not simply allocating optimally, but also really making sure that there is a balance between price and risk. BMO takes a diversified approach to alpha generation rather than focusing on a single factor. That is particularly important in a cycle like this one, where many segments have had lots of time to mature.

Today’s market may give institutional investors an opportunity to pull back from some of their more exotic investments without sacrificing the potential for yield.

“With the 10-year at over 3% and investment-grade corporates yielding 4% of the index level, we can certainly get to 5% through security selection and active management,” she said, referring to the U.S. Treasury’s 10-year bond yield.

“So investors can take a little bit of a step back,” she said, “and within the context of their broader asset allocation, pick up the diversification elements of interest rates or high-quality corporates while at the same time achieving their return assumptions.” ■

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