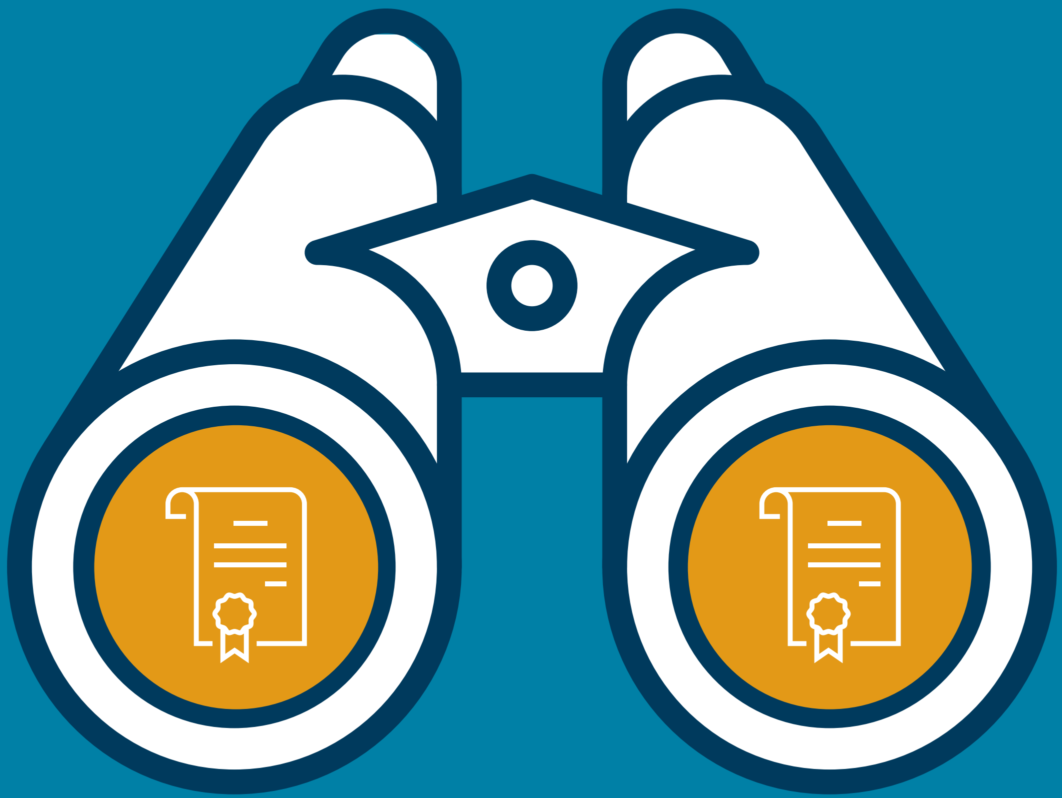

2018 FIXED INCOME INVESTING SURVEY

REFOCUSING ON THE BENEFITS OF BONDS

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WHERE ACCESS EQUALS OPPORTUNITY

Refocusing on the benefits of bonds

PAUL MOTTOLA
Managing Director
Head of Capital Markets

With a prolonged low interest rate environment, and an extended period of strong equity returns, investors seeking income in their investment portfolios might have become comfortable taking on equity risk to accomplish their income needs.

We surveyed 200 financial advisors to uncover their perceptions and behaviors regarding fixed income investing as it relates to their clients. It became clear that in light of current market conditions, a large proportion of surveyed advisors indicated that it would take a significant correction in the equity markets for investors to appreciate the benefits of fixed income. In fact, more than half of those surveyed are expecting clients to increase asset allocation to fixed income or cash over the next 12 months.

With increased volatility in the market, we believe investors will now be far more receptive to assessing the features of fixed income, such as portfolio diversification and lower volatility. This is especially true among investors who have taken equity risk for income, and those who now may be focused on principal protection and a fixed and a more predictable stream of income. The survey showed that the two primary assets investors have been using to generate income are dividend-paying stocks and equity income mutual funds.

Despite having single security market and credit risk, the features that bonds provide are particularly appealing right now. Bonds offer predictable income, return of principal at maturity (absent issuer defaults), if bought at par, and portfolio diversification, which may improve clients' risk-adjusted returns. Most bond ETFs provide many important benefits, such as portfolio diversification and market liquidity. However, their income is generally not fixed, and in many cases their interest rate sensitivity remains constant over time, unlike a bond, which declines over time as the maturity date grows closer. This is an important consideration, especially given the risk of rising interest rates and how that may impact a client's portfolio.

It is important to note that individual bonds are intended to be held to maturity. If they are sold prior to maturity, there may not be an active secondary market and the investor could receive less than the original investment.

With equity market volatility increasing more recently, it has become critical for advisors to review clients' portfolios, recognize the inherent risks associated with certain equity income securities and consider the diversification benefits of traditional fixed income securities.

In the following report, we are pleased to share the results of the *2018 Incapital Fixed Income Investing Survey*. The valuable insights provided from advisors portray a clear picture about how they and their clients view various asset classes in both the previous and current market environments, as well as their anticipated future behavior. Furthermore, the survey offers interesting advisor perspectives around the fixed income business in general and how this shapes their own business. Industry professionals can take away some important insight on areas to improve and concentrate on in 2019.

Where are the assets?

The influence of one of the longest equity bull markets on record was evident when we surveyed advisors about the current asset allocation among their clients.

Current Asset Allocation[1]

46% Equities

27% Fixed Income

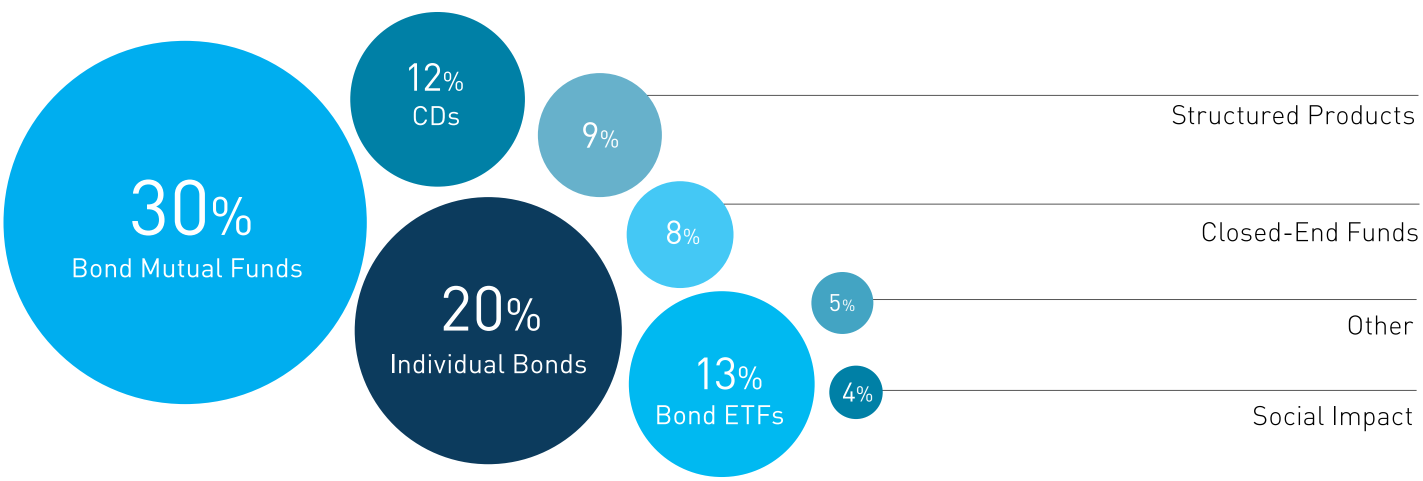
14% Cash

9% Alternatives

4% Other

Fixed Income Product Breakout

Among the AUM allocated to fixed income product types, the breakout of specific fixed income products shows strong weightings to bond mutual funds and individual bonds.



Individual Bond Product Breakout

Advisors identified the percentage of their clients' portfolios that hold each type of individual bond. In many cases, multiple types of bonds were held in these portfolios.

Municipal bonds	63%
Corporate bonds	54%
High-yield bonds	48%
Treasury bonds	40%
Short-term bonds	39%

International bonds	22%
Mortgage-backed securities	20%
Agency bonds	18%
Social Impact bonds	17%

[1] As of the survey period of September 20-October 1, 2018

Time to think differently about fixed income?

While advisors said it would take a significant equity market event for investors in general to recognize the benefits of fixed income, they're not waiting for it to happen when it comes to their clients. Half of the surveyed advisors said they expect their clients would be increasing allocations to fixed income or cash over the next 12 months, with far fewer (29%) saying they expect an increase in equities.

Expected Asset Allocation Changes Over the Next 12 Months (increase vs. decrease)[1]

↑29% vs. ↓22%
Equities

↑34% vs. ↓12%
Fixed Income

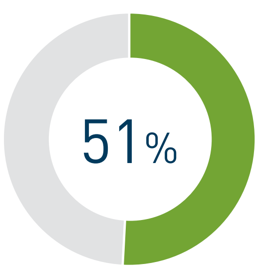
↑33% vs. ↓12%
Cash

↑21% vs. ↓9%
Alternatives

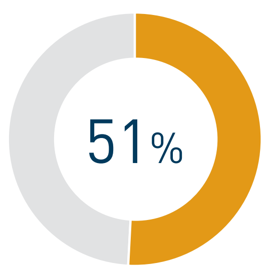
↑15% vs. ↓9%
Other

The Primary Reasons Advisors are Using Individual Bonds in Client Portfolios

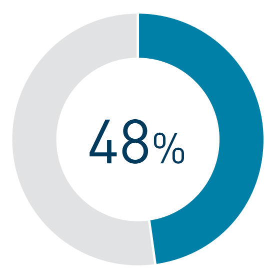
With advisors expecting fixed income allocations to increase over the next 12 months, we look to their primary reasons for investing in bonds to understand how these features may be more attractive in volatile equity markets.



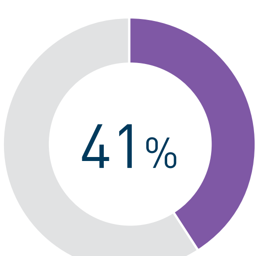
Diversification



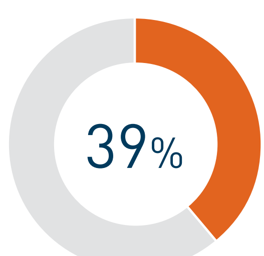
Predictable Income



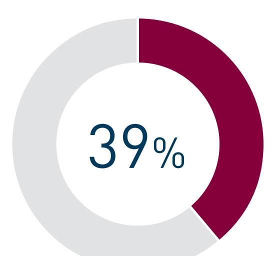
Tax Efficiency



Client Preference



Minimize Volatility



Total Return

[1] As of the survey period of September 20-October 1, 2018

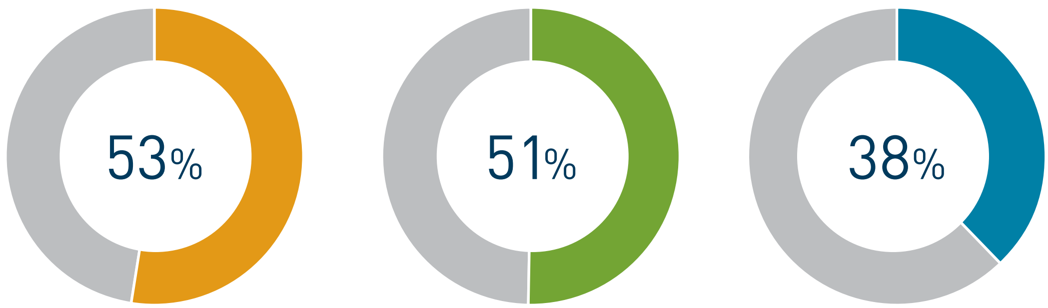
Back to basics?

The long-term equity bull market and sustained low interest rates have created an environment where investors are using equities and equity-like funds to generate portfolio income. This explains why 64% of surveyed advisors believe bond ETFs have changed the definition of fixed income investing away from predictable income and return of principal to fixed income *exposure*.

Three-quarters (76%) of surveyed advisors believe principal protection is a top priority for their clients.

Almost two-thirds (64%) of advisors believe that Bond ETFs have changed the definition of fixed income investing away from predictable income and return of principal to fixed income *exposure*.

Top Fixed Income Benefits

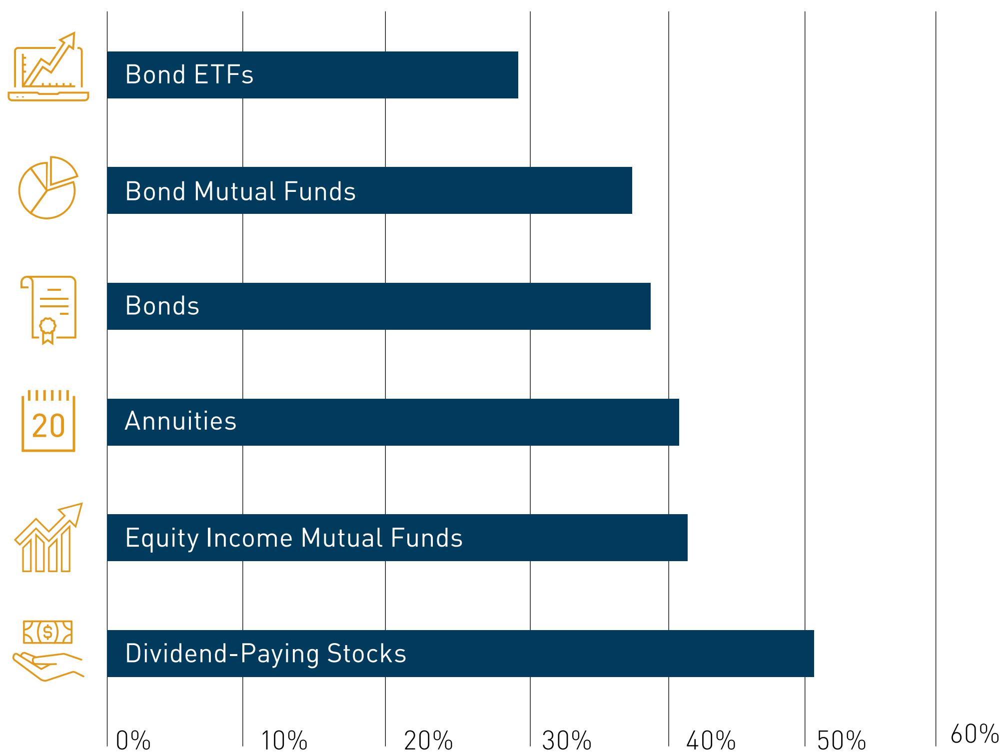


Predictable rate of income

Portfolio Diversification

Return of principal at maturity

Investment Vehicles Used to Generate Income



Barriers to fixed income?

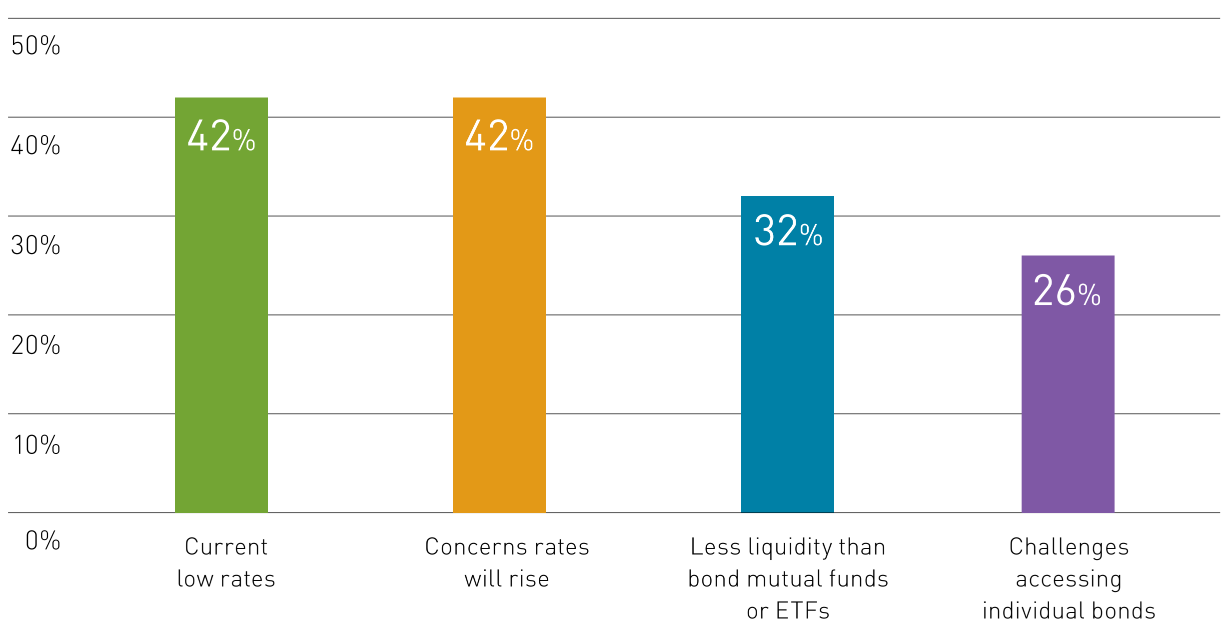
The risk of rising rates was the advisors' top-ranked concern with fixed income investing, followed by finding good fixed income solutions in a low rate environment, and generating income without increasing portfolio risk.

The Biggest Challenges Advisors Have with Fixed Income Investing

It comes as no surprise that advisors were particularly bullish on bond ladders, with 80% saying bond ladders are extremely effective at helping investors manage their interest rate risk.

Major Barriers to Investing in Individual Bonds

Whether it's rates or concerns about access and liquidity, there are some barriers that have advisors concerned about investing in individual bonds. In some cases, these barriers may be overcome with greater access to information about, for example, types of bonds available to individual investors.



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Where do we go from here?

When asked their view of bond rates going forward, the majority of advisors agree that by October 2019 short-term bond rates will be either greater than they are today (70%), or the same as today (18%). Only 12% thought rates would be lower. An even greater number (80%) thought long-term rates would be greater than today, 16% believe they will remain the same, and only 4% believe they will decrease.

Among advisors who believe rates will either stay the same or increase over the next 12 months, the view is split on how significant that change will be.

Bonds with **less than 5 years** to maturity (short-term)[1]

35%

Believe rates will increase **less than 1%**

27%

Believe rates will increase from **1% to less than 2%**

8%

Believe rates will increase from **2% to less than 3%**

Bonds with **more than 5 years** to maturity (long-term)[1]

24%

Believe rates will increase **less than 1%**

34%

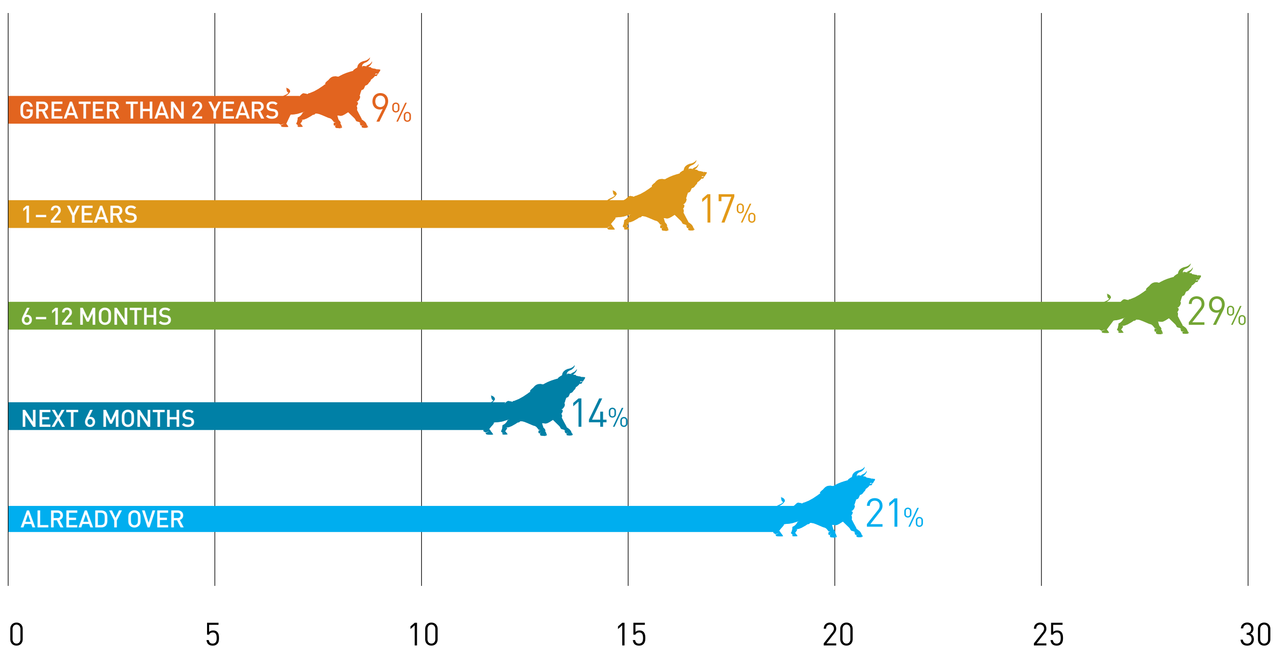
Believe rates will increase from **1% to less than 2%**

22%

Believe rates will increase from **2% to less than 3%**

Time until Bond Bull Market Ends

According to many advisors surveyed, the bond bull market may be coming to an end, if it hasn't already.[1]



[1] As of the survey period of September 20 - October 1, 2018

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About the Survey

The *Incapital Fixed Income Investing Survey* was conducted by Q8 Research LLC using a quantitative online survey methodology. A total of 200 financial advisors across channels completed the survey during the period September 20 to October 1, 2018. It was conducted among a diverse set of respondents from various firms, including wire houses, regional dealers, independent dealers, as well as banks and RIAs. The survey's objective was to uncover insights about financial advisors' perceptions and behaviors regarding fixed income investing, client asset allocations broadly, as well as looking specifically within the fixed income sector. All respondents have 3+ years tenure as a financial advisor and are involved in portfolio construction decision-making with their clients.

About Incapital

Incapital was founded in 1999 and today is a leading underwriter and distributor of securities to more than 800 broker-dealers, institutions, asset managers, RIAs and banks. The firm represents more than 300 issuing entities and has underwritten more than $470 billion in securities. The firm is headquartered in Chicago, IL and has a principal office in Boca Raton, FL.

Learn More

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