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Bond Market Update
Bullets, Barbells and Ladders: Strategies to Consider When Rates Decline

By Bill Smith, Fixed Income Trader and Portfolio Manager

With the Federal Reserve (Fed) telegraphing three rate cuts this year, and Bloomberg's probability model estimating at least five as of January 23, we will likely see lower rates in 2024. If this scenario plays out, fixed income should perform well, as bond prices generally rise when rates fall. This is especially true for intermediate and long bonds, which typically outperform short maturities when rates drop. Given this dynamic, an allocation to longer maturities appears prudent for individual fixed income portfolios. While there are numerous ways to attain long exposure, bullet, barbell and laddered strategies are the most common. Each has a distinctly different structure that should be considered when deciding between strategies.

Bullet – Specific Maturity Target

As the name suggests, a bullet strategy involves purchasing bonds with a specific maturity target. For instance, an investor might focus exclusively on one-year bonds, or only invest in twenty-year maturities. While this is one of the simplest strategies to execute, its focus on a specific maturity range means it is also the least flexible. Furthermore, longer bullet strategies carry significant interest rate risk, and force investors to make a bet on a single point on the yield curve. As such, bullet strategies are typically best for shorter time horizons when planning for future liquidity needs. For example, if you are sending a child to college in three years, you can buy three-year bonds that mature before the first tuition payment is due.

Barbell – Skip the Middle

While barbell strategies come in all shapes and sizes, most involve allocating capital to shorter term maturities, avoiding intermediate and investing in long. The longer end of the barbell provides duration exposure and offers more certainty around future cash flows, while the short end lowers overall portfolio volatility and provides more flexibility as bonds mature. Just like a bullet, barbell strategies involve making specific yield curve bets by excluding intermediate bonds, resulting in a portfolio that is overweight both short and long bonds.

Ladder – Broad Exposure

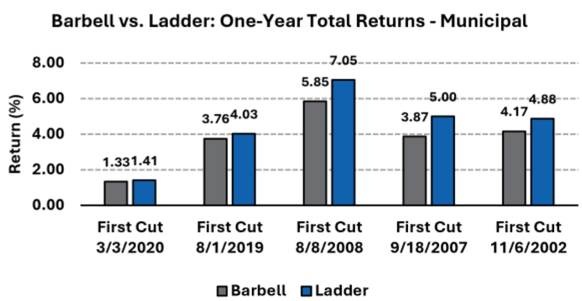
In a laddered strategy, investors attempt to evenly distribute maturities across their investment horizon, providing exposure to short, intermediate and long bonds. When the shortest bond in the ladder (rung) matures, proceeds are reinvested into the longest end, keeping duration relatively stable. While the length of both barbells and ladders can be customized, a laddered strategy does not make specific yield curve bets over its investment horizon. Once the length of the ladder is established, broad exposure is the goal.

Choosing a Strategy

Selecting an appropriate strategy will largely depend on each investor's unique situation. That said, we believe a diversified approach to maturity selection is prudent and would exercise caution when considering a bullet strategy for long bond exposure. Along those lines, barbells also take a less diversified approach to maturity selection and typically exclude intermediate bonds. Balancing the duration of a barbell also requires a significant allocation to short maturities, increasing reinvestment risk and potentially leading to underperformance in a falling rate environment. Since a laddered strategy offers broad diversification across the yield curve and can be built to reduce short maturity exposure, we expect most laddered structures will perform well if rates fall.

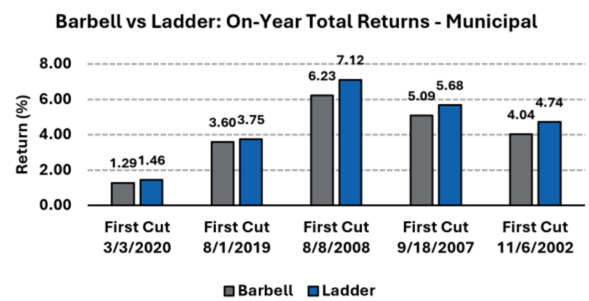
To help illustrate this point, we analyzed the historical performance of several municipal and corporate bond portfolios at the beginning of previous Fed easing cycles. For this analysis, the charts below, "Municipal Scenarios" and "Corporate Scenarios," focus exclusively on barbell and laddered structures:

Municipal Scenarios



Index	Barbell (% Weight)	Ladder (% Weight)
Ice BofA 1-3 Year Municipal	50%	20%
Ice BofA 3-5 Year Municipal	-	20%
Ice BofA 5-7 Year Municipal	-	20%
Ice BofA 7-10 Year Municipal	-	20%
Ice BofA 10-15 Year Municipal	50%	20%

Effective Duration	4.07	4.07
Avg. Ladder Outperformance	68 Basis Points	



Index	Barbell (% Weight)	Ladder (% Weight)
Ice BofA 1-3 Year Municipal	50%	25%
Ice BofA 3-5 Year Municipal	-	25%
Ice BofA 5-7 Year Municipal	-	25%
Ice BofA 7-10 Year Municipal	50%	25%

Effective Duration	3.35	3.43
Avg. Ladder Outperformance	50 Basis Points	

Source: ICE BofA Indexes, Bloomberg. Past performance is no guarantee of future results. Scenarios are hypothetical.

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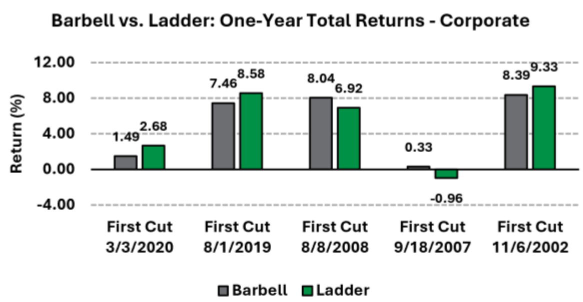
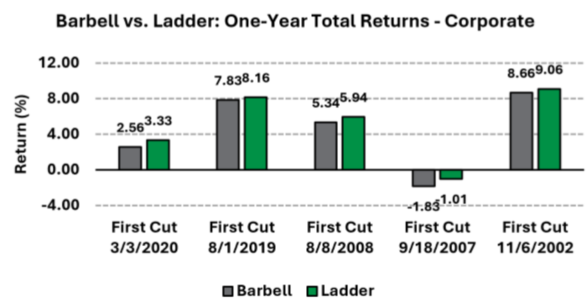
Corporate Scenarios



Index	Barbell (% Weight)	Ladder (% Weight)
Ice BofA 1-3 Year U.S. Corp	50%	20%
Ice BofA 3-5 Year U.S. Corp	-	20%
Ice BofA 5-7 Year U.S. Corp	-	20%
Ice BofA 7-10 Year U.S. Corp	-	20%
Ice BofA 10-15 Year U.S. Corp	50%	20%

Effective Duration	5.21	5.13
Avg. Ladder Outperformance	17 Basis Points	



Index	Barbell (% Weight)	Ladder (% Weight)
Ice BofA 1-3 Year U.S. Corp	50%	25%
Ice BofA 3-5 Year U.S. Corp	-	25%
Ice BofA 5-7 Year U.S. Corp	-	25%
Ice BofA 7-10 Year U.S. Corp	50%	25%

Effective Duration	4.22	4.23
Avg. Ladder Outperformance	58 Basis Points	

Source: ICE BofA Indexes, Bloomberg. Past performance is no guarantee of future results. Scenarios are hypothetical.

While not exhaustive, this analysis demonstrates that when durations are similar, ladders have the potential to outperform barbells in a falling rate environment. With attractive yields available across fixed income sectors and maturities, a diversified maturity distribution should be an important consideration when building fixed income portfolios.

A prudent approach to fixed income investing calls for diversification across both credit and duration exposure. As always, Dynamic recommends staying balanced, diversified and invested. Despite short-term market pullbacks, it's more important than ever to focus on the long-term, improving the chances for investors to reach their goals.

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