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The risks of chasing yield

Before boosting your portfolio's yield, consider the risks.

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Investing Strategies Bonds Mutual Funds

Investors used to be able to generate healthy income from safe, stable bonds such as intermediate-term Treasuries. In July 1987, the five-year Treasury note offered a yield of more than 8%. No longer: Recently, the yield on the five-year Treasury note sat at just 0.76%, well below the rate of inflation.

Investing in lower-quality or longer-dated bonds has offered more yield than Treasuries or high quality municipal bonds. The average yield on the Merrill Lynch Global High Yield Constrained Index recently was 7.76%, while the 30-year Treasury bond recently paid 2.63%. But these higher yielding options carry significantly more risk.

"There's really no way to add yield without taking on more risk," says Jeff Moore, portfolio manager of Fidelity Investment Grade Bond Fund. "But there are ways to do it prudently."

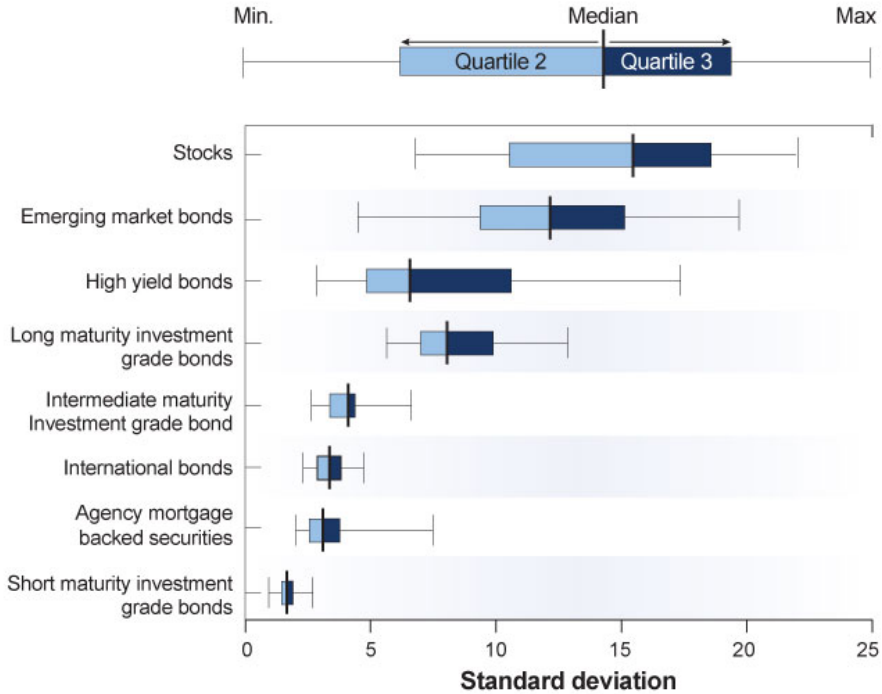
Begin by recognizing the role bonds play in *your* overall portfolio. Do you own bonds to generate income in retirement? Or are they there to balance the risk of stocks? And when will you need the money? The answers to these questions will help you decide how much risk you are willing to take in your bond portfolio.

How great is the risk?

Historically, bonds in general have had less risk than stocks. Still, not all bonds are created equal. As you can see in the chart below, bonds with lower credit quality or longer terms tend to be far more volatile (as measured by the standard deviation of indexes). In fact, high-yield bonds have two to three times the risk in terms of price volatility as investment-grade and intermediate-term bonds.

Not all bonds come with the same level of risk.

Annualized Standard Deviation: Historical Ranges April 1987 - April 2012



For illustration only. Short-maturity investment-grade bonds represented by Barclays Capital (BC) U.S. 1-3 Yr Government/Credit Bond Index, Mortgage-backed securities represented by BC U.S. MBS Index, international bonds represented by BC U.S. International Government/Credit Bond Index, investment-grade bonds represented by BC U.S. Aggregate Bond Index, Long-maturity investment-grade bonds represented by BC U.S. Long Government/Credit Bond Index, high yield represented by BC U.S. Corporate High-Yield Index, Emerging market bonds represented by BC U.S. Emerging Markets Index, and stocks represented by the S&P 500® Index. Source: FMRCo. Standard deviation measures the volatility of a returns.

Longer-term and, in particular, lower-quality bonds can be subject to the kind of big and sudden moves that most associate with the stock market.

Consider the chart to the right. Between 1994 and 2011, the largest one-year loss for 30-year Treasuries was -14.9%, and for high yield bonds -30.8%, while the worst year for intermediate-term investment-grade bonds was only -3.7%.

"With investment-grade bonds, you don't focus on how much money you make," says Moore. "You focus on the fact that while there are risks to quality bonds, there were very few periods when these bonds had negative returns and that higher quality bonds are negatively correlated to stocks and other risk assets, including high yield. I see a trade out of investment grade and into high yield as more than a stretch for yield—it's a leap."

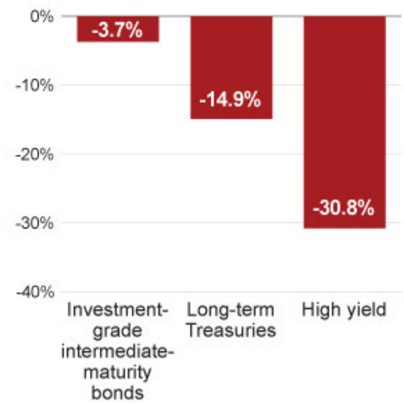
But what if you need additional income and can accept the price volatility that comes with it? Perhaps you're an individual bond investor and don't need to redeem your bonds before maturity. In that case, price volatility is less important; as long as your issuer doesn't default, you can pay less attention to the market value of the bond and focus more on the interest payments. Still, it's important to understand the two primary types of risk you are taking on as you reach for higher yield.

Credit risk: This is the risk that a bond issuer will default on its obligations. High-yield bonds are issued by companies with lower credit ratings and some emerging market sovereign governments. These high-yield bonds, as well as other income-producing investments such as real estate debt, preferred securities, and dividend-yielding stocks, have more risk of default than investment-grade bonds, but also higher yields. Today the spread between Treasuries and high-yields is over 6%. What's more, if interest rates rise, that higher coupon can help offset some of the losses that rising rates might have on the impact of the market value of a bond.

"The risk profile of high-yield bonds is different than other bonds, but the yield is still attractive relative to investment-grade assets," says Matt Conti, manager of Fidelity Focused High Income Fund. "I'm comfortable with the relative value of high yield at this level, given the way the market is pricing in the risk of a liquidity issue and what I think is the relatively benign outlook for defaults."

How much of a loss can you stomach?

Largest 1-year loss, 1994-2011



Source: Long-term Treasuries represented by Ibbotson Associates Long-Term Government Bond Index; high-yield bonds by Bank of America Merrill Lynch High Yield Master Index. Sources: Haver Analytics, prepared by FMRCo (FMR AAR); Ibbotson SBBI 2012 *Classic Yearbook*.

Interest rate risk: In general, when interest rates rise, bond prices fall, and longer-term bonds are more sensitive to changes in interest rates. The price on a 30-year Treasury bond will typically fall about four times more than the price on a five-year Treasury bond if interest rates rise by one percentage point. While rates are extremely low by historical measures, that doesn't mean rates are about to rise. "The low-yield environment doesn't seem likely to change anytime soon, though it is important to know what the impact could be when and if it does," says Ford O'Neil, manager of Fidelity Total Bond Fund.

Managing credit and interest risk in your portfolio

While high-yield and longer-term bonds may be appropriate for some investors, others may not be so risk tolerant. The key is to start with your personal risk tolerance and goals. No one likes accepting paltry returns on investments, but you may have the money to maintain your lifestyle without big gains and not be able to stomach the type of losses that higher yielding or longer maturity options have delivered in the past. Or you may not like the idea of risk, but feel that your need for current income justifies taking on that additional potential volatility. The answers depend on your personal situation. Here are a couple of ideas.

Take a baby step out the risk spectrum. If you invest in high quality bonds but are looking for more yield, you may have options short of adding a significant allocation of high-yield bonds to your portfolio. You may want to look to bonds that offer incrementally more yield, but are near the historical risk level that you target for your portfolio. (To find bonds with similar levels of risk, see the chart above: Not all bonds come with the same level of risk.)

For instance, investment-grade bonds and agency MBS bonds have had fairly similar levels of volatility, but these days moving from Treasuries to agency MBS bonds gives an investor the potential for a pickup in yield. While these bonds add some risk, they generally provide higher yield without the much higher risk of lower-quality or longer-term bonds. Making portfolio changes that offer incremental yield—either on your own or through a diversified fund—while maintaining similar levels of risk could help you build a portfolio that fits with your risk tolerance and potentially generates more income.

Diversify into a riskier mix. If you do decide to take on more risk, instead of simply trading a higher quality bond for a riskier one, consider creating a strategic mix of bonds to help capture higher yield and manage risk. A diversified mix won't guarantee against a loss, but it may be able to add some additional return potential without adding as much risk as simply moving from higher quality bonds to lower quality bonds.

Why does diversification work? Consider the correlations various types of fixed-income securities have exhibited with the S&P 500 over the past 10 years. As you can see, the highest quality sectors' returns frequently move counter to the direction of the stock market, while lower-quality sectors tend to correlate significantly with equities.

Some types of bonds perform well in different markets.

10-year correlation through 4/30/12

Treasury (Barclays Capital [BC] U.S. Treasury)	Mortgage- Backed Securities (BC U.S. MBS)	Investment-Grade Bonds (BC Aggregate)	Corporate Bonds (BC Credit)	Emerging Market Debt (BC U.S. Emerging Market)	High Yield (BC U.S. Corp High Yield)

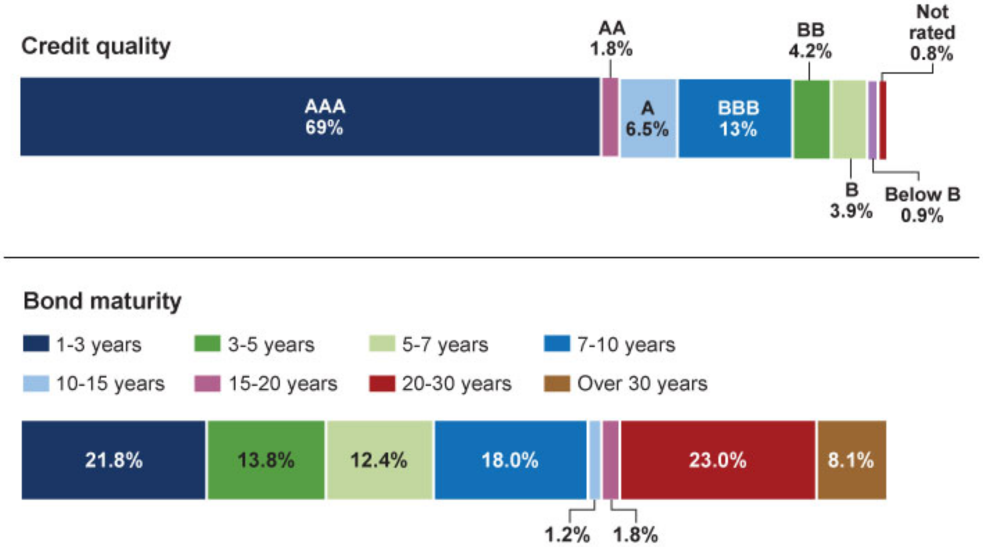
S&P 500	-0.34	-0.15	-0.05	-0.32	0.61	0.70

Note: Perfect correlation is measured as 1.0; a negative correlation indicates that the asset tends to move in the opposite direction from stocks at any given time. Data from FMRCo.

To take advantage of the different factors that impact bond performance and to get a bit more yield, you might want to add an allocation of higher yielding bonds along with higher quality bonds. Let's look at an example of how a mix of credit qualities and durations might be put together, using the top intermediate-term bond fund in Fidelity Funds Picks[1]—Fidelity Total Bond Fund (see below). The normal strategy of this fund is to invest at least 80% of assets in debt securities of all types and up to 20% in high-yield and emerging market debt. The goal: to achieve a higher level of current income than with a pure investment-grade bond fund. (For more details, including performance, see the fund's prospectus.)

Fidelity Total Bond Fund

A mix with more risk than an investment-grade fund but higher yield potential



Source: Morningstar, as of 6/30/2012. See footnotes for definitions of credit ratings.

The key, of course, is to make good strategic decisions based on your risk tolerance, timeline, and investing goals. Broad diversification can help. Otherwise, you could end up adding more risk to your portfolio than you are comfortable with, and that could cause problems when the market changes.

Next steps

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Past performance is no guarantee of future results.

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1. Based on Fidelity Funds Picks for Intermediate Bonds ranked on five-year average annual returns as of August 16, 2012. The funds on the Fund Picks From Fidelity® list are selected based on certain selection criteria. Fund Picks From Fidelity is not a personalized recommendation or endorsement of any fund for an investor's individual circumstances. For more details about fund picks, visit Fund Picks from Fidelity. (R)

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Unlike individual bonds, most bond funds do not have a maturity date, so holding them until maturity to avoid losses caused by price volatility is not possible. Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

The risk of default on principal, interest, or both, is greater for high-yield bonds than for investment-grade bonds.

Credit ratings are forward-looking opinions about credit risk. Standard & Poor's credit ratings express the agency's opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time. Credit ratings can also speak to the credit quality of an individual debt issue, such as a corporate note, a municipal bond, or a mortgage-backed security, and the relative likelihood that the issue may default. 'AAA'—Extremely strong capacity to meet financial commitments. Highest Rating.

'AA'—Very strong capacity to meet financial commitments. 'A'—Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances. 'BBB'—Adequate capacity to meet financial commitments, but more subject to adverse economic conditions. 'BBB'—Considered lowest investment grade by market participants. 'BB+'—Considered highest speculative grade by market participants. 'BB'—Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions. 'B'—More vulnerable to adverse business, financial, and economic conditions but currently has the capacity to meet financial commitments. 'CCC'—Currently vulnerable and dependent on favorable business, financial, and economic conditions to meet financial commitments. 'CC'—Currently highly vulnerable. 'C'—Currently highly vulnerable obligations and other defined circumstances. 'D'—Payment default on financial commitments.

Any fixed income security sold or redeemed prior to maturity may be subject to loss.

Interest income generated by Treasury bonds and certain securities issued by U.S. territories, possessions, agencies, and instrumentalities is generally exempt from state income tax but is generally subject to federal income and alternative minimum taxes and may be subject to state alternative minimum taxes.

Indexes are unmanaged and you cannot invest directly in an index.

Investments in mortgage securities are subject to the risk that principal will be repaid prior to maturity. As a result, when interest rates decline, gains may be reduced, and when interest rates rise, losses may be greater.

Barclays Capital U.S. Aggregate Bond Index is a market value–weighted index of investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities, with maturities of one year or more.

Barclays Capital 3+ Year Non-Amt Municipal Bond Index is a market value–weighted index of investment-grade fixed-rate Non–Alternative Minimum Tax (AMT) municipal bonds with maturities of three years or more.

JPMorgan Emerging Markets Bond Index is a market value–weighted index of U.S. dollar–denominated sovereign restructured debt issues. BofA Merrill Lynch U.S. High Yield - Master II Constrained. The BofA Merrill Lynch US High Yield Constrained Index is a modified market capitalization–weighted index of U.S. dollar–denominated, below-investment-grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below-investment-grade rating (based on an average of Moody's, S&P, and Fitch) and an investment-grade rated country of risk. In addition, qualifying securities must have at least one year remaining to final maturity, a fixed coupon schedule, and at least $100 million in outstanding face value. Defaulted securities are excluded. The index contains all securities of The BofA Merrill Lynch U.S. High Yield Index but caps issuer exposure at 2%.

The S&P 500 Index is a market capitalization–weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

Barclays Capital U.S. Emerging Markets Bond Index is a market value–weighted index of fixed- and floating-rate emerging markets debt securities that are U.S. dollar denominated and are below investment grade. The index is designed to measure the performance of emerging market debt securities in the Americas, Europe, Asia, Middle East, and Africa.

Barclays Capital U.S. Corporate High-Yield Bond Index is a market value–weighted index that covers dollar-denominated, fixed-rate, below-investment-grade debt securities.

Barclays Capital U.S. Long Government/Credit Bond Index is a market value–weighted index of investment-grade fixed-rate public obligations of the U.S. Treasury and U.S. Corporate Indices with maturities of ten years or more.

Barclays Capital U.S. Intermediate Government/Credit Bond Index is a market value–weighted index of investment-grade fixed-rate debt securities with maturities from one up to (but not including) ten years from the U.S. Treasury, U.S. Government-Related, and U.S. Corporate Indices.

Barclays Capital U.S. MBS Index is a market value–weighted index of fixed-rate securities that represent interests in pools of mortgage loans with original terms of 15 and 30 years that are issued by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Corp. (FHLMC), and balloon mortgages with fixed-rate coupons.

Barclays Capital U.S. 1-3 Year Government/Credit Bond Index is a market value–weighted index of investment-grade fixed-rate debt securities with maturities from one to three years from the U.S. Treasury, U.S. Government-Related, and U.S. Corporate Indices.

The Ibbotson Long-Term Government Bond Index is a total return index of all public organizations of the U.S. Treasury except flower bonds and foreign-targeted issues. All bonds have maturities of at least 10 years or more. The returns are weighted by market value including accrued interest. The bonds represented in this index are backed by the U.S. government, yet involve risk of principal loss if sold prior to maturity.

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