STUDY SESSION 5

Fixed-Income Portfolio Management (1)

Fixed-income securities represent a significant portion of all available financial assets and are included in most investor portfolios.

This study session begins by explaining the role played by fixed-income securities in portfolios and then introduces the two primary types of fixed-income mandates (liability-based and total return). A model for decomposing expected bond returns, which identifies the driving forces behind expected returns, is presented. Fixed-income portfolio risk measures such as duration and convexity are addressed, and the effects of liquidity, leverage, and taxes on fixed-income portfolios are discussed. The session reviews alternatives to direct bond investments such as mutual funds and exchange-traded funds as well as fixed-income derivatives and their role in a portfolio. Next, liability-driven and index-based strategies are examined in greater detail. Coverage includes approaches, risks, and challenges associated with both immunization of single and multiple liabilities and the indexation and laddering of a fixed-income portfolio. Primary risk factors associated with an index, enhanced indexing and benchmark selection are also covered in this session.

READING ASSIGNMENTS

Reading 11	Overview of Fixed-Income Portfolio Management by Bernd Hanke, PhD, CFA, and Brian J. Henderson, PhD, CFA
Reading 12	Liability-Driven and Index-Based Strategies by James F. Adams, PhD, CFA, and Donald J. Smith, PhD

LEARNING OUTCOMES

READING 11. OVERVIEW OF FIXED-INCOME PORTFOLIO MANAGEMENT

The candidate should be able to:

- **a** discuss roles of fixed-income securities in portfolios and how fixed-income mandates may be classified;
- **b** describe fixed-income portfolio measures of risk and return as well as correlation characteristics;
- **c** describe bond market liquidity, including the differences among market sub-sectors, and discuss the effect of liquidity on fixed-income portfolio management;
- **d** describe and interpret a model for fixed-income returns;
- **e** discuss the use of leverage, alternative methods for leveraging, and risks that leverage creates in fixed-income portfolios;
- **f** discuss differences in managing fixed-income portfolios for taxable and tax-exempt investors.

READING 12. LIABILITY-DRIVEN AND INDEX-BASED STRATEGIES

The candidate should be able to:

- **a** describe liability-driven investing;
- **b** evaluate strategies for managing a single liability;
- **c** compare strategies for a single liability and for multiple liabilities, including alternative means of implementation;
- **d** describe construction, benefits, limitations, and risk–return characteristics of a laddered bond portfolio;
- **e** evaluate liability-based strategies under various interest rate scenarios and select a strategy to achieve a portfolio's objectives;
- **f** explain risks associated with managing a portfolio against a liability structure;
- **g** discuss bond indexes and the challenges of managing a fixed-income portfolio to mimic the characteristics of a bond index;
- **h** compare alternative methods for establishing bond market exposure passively;
- **i** discuss criteria for selecting a benchmark and justify the selection of a benchmark.