High-coupon bonds during times of uncertainty

Wealth Management

Bond investors are often exposed to numerous factors in the market that can lead to uncertainty and elevated volatility, such as inflation, adjustments in Federal Reserve policy, and global politics, to name a few. Thus, during times of uncertainty fixed income portfolio managers will often gravitate toward high-coupon bonds as a strategy to help reduce downside risk from rising interest rates and/or widening risk premiums. All else being equal, while targeting high-coupon bonds may sacrifice some total-return potential from dollar price appreciation, we think the benefits of high-coupon bonds outweigh the possibility of greater price appreciation during times of elevated uncertainty.

High-coupon strategies

Targeting bonds with large coupons typically means investors must pay a premium dollar price (above par). And while many investors are averse to this idea, purchasing bonds with high coupons can be an effective way to increase cash flow and current yield to a portfolio. This approach can allow investors to buy longer-maturity bonds at a shorter duration, which can reduce volatility compared to smaller-coupon bonds with the same maturity date. For those investors who may be hesitant about buying longer-maturity bonds, targeting bonds with large coupon characteristics may be a worthwhile strategy to lock in attractive cash flows for longer with defensive characteristics. In turn, higher cash flows generated by large coupons can help investors weather elevated inflation and widening credit spreads, as well as reduce potential risks from rising Treasury yields.

All things considered, there is a give-and-take to this strategy. Since high-coupon bonds can be less volatile, they often underperform low-coupon bonds when interest rates are declining because of their typically lower sensitivity to changes in prevailing interest rates. Even though economic growth and inflation can be cyclical, there are many occasions when economic growth and yields rise despite assumptions of a downturn. We saw a good example of this in 2024 when long-term yields consistently headed lower from April to September due to market expectations that slower job growth and consumer spending may lead to a near-term recession. Instead, the economy continued to show evidence of resilient growth while the yield on the 30-year Treasury benchmark advanced over 100 basis points from September to mid-January 2025.

Bond volatility depends on two factors

A bond's volatility, or duration, refers to the degree of price fluctuation over time from rising or falling interest rates. The general rule is that a bond's volatility depends on two factors: the coupon rate and the length of time until the bond is retired (at maturity or call date). One common misconception is that some investors only account for timeline when measuring volatility, whereas incorporating the coupon is an important component in the calculation of duration. In practice, the effect of interest rate fluctuations on volatility can be reduced by the amount of coupon payments an investor receives over the life of the bond.

For example, if two bonds from a particular issuer have the same maturity date, the one with the higher coupon rate will be less volatile to prevailing interest rates. However, if two bonds from a same issuer have the same coupon rate, the bond with the longer maturity date will likely be more volatile. Because duration reflects price volatility, average duration is often more meaningful than average maturity from a portfolio management standpoint. As a result, purchasing higher-coupon bonds may allow investors to position their portfolios to outperform bonds with lower-coupon structures when Treasury yields rise.

For important disclosures see page 3.

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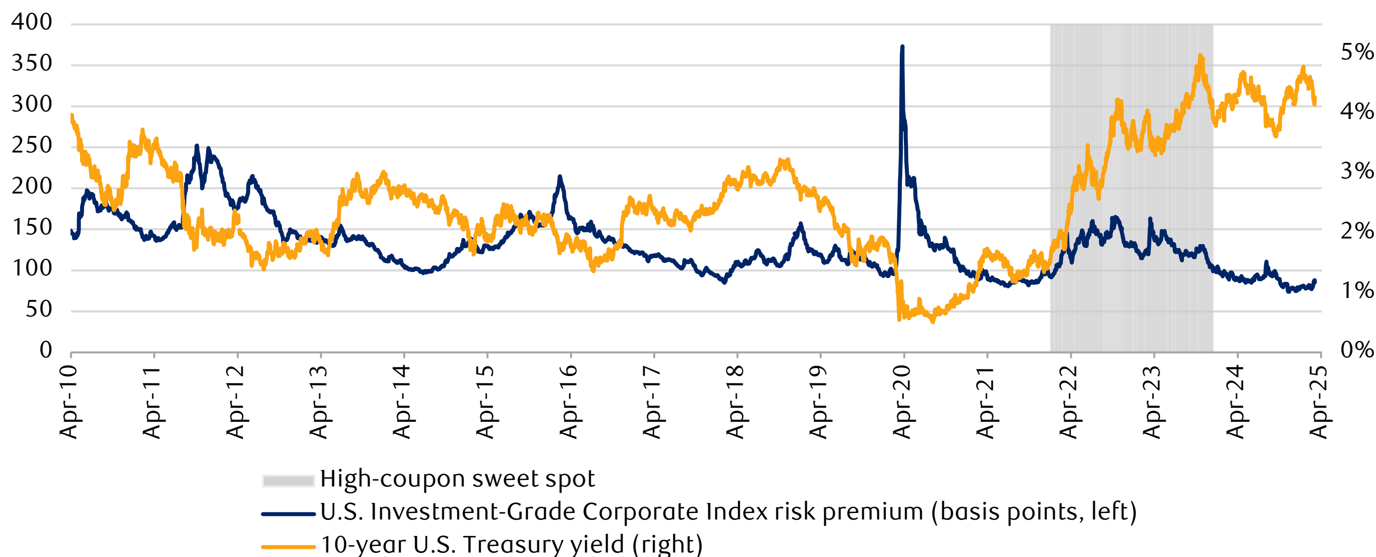
2022 and 2023 issues are the sweet spot for large coupons, as both yields and risk premiums were elevated



Source - Bloomberg

Coupons are largely influenced by interest rates and risk premiums

Most U.S. corporate bonds are issued with a fixed coupon that's based on prevailing interest rates in the Treasury bond market. Since most corporate bonds are issued at or near par ($100) in the primary market, their fixed coupons are often higher than comparable new-issue Treasury bonds to compensate investors for greater credit risk. While new-issue coupons priced by lower-rated issuers often pay larger coupons compared to higher-rated issuers, investors often can find higher-quality bonds in the secondary market that pay above-market coupons. Although it requires paying a premium dollar price, investors can generate attractive cash flows from an issuer with sound credit fundamentals.

Bonds issued in 2022 and 2023 can be the sweet spot for finding high coupons

Because Treasury yields and risk premiums fluctuate with the economy, bonds with large coupon characteristics are typically issued during periods of elevated interest rates, historically wide risk premiums, or a combination of both. While Treasury yields are an important factor that determines the size of coupons, risk premiums can play an equal role, which also fluctuate depending on the overall health of the economy.

Risk premiums tend to widen when the economy is under pressure as investors demand greater compensation for "owning risk," and vice versa when economic growth is strong. As illustrated in the chart, there have been several events that caused risk premiums to widen sharply since 2010. While brief, the largest move took place in early 2020 brought by the pandemic. However, we think the sweet spot for targeting large coupons can be found in bonds issued in 2022 and 2023, when both Treasury yields and risk premiums were elevated as the Fed battled inflation while markets were cautious of an imminent recession.

You know what they say, cash is king

In our view, targeting bonds with high coupons can be a worthwhile strategy for investors to generate greater cash flows as a more reliable source of returns in scenarios with turbulent markets. The defensive characteristics of high-coupon bonds can allow investors to lock in longer-term cash flows with greater defensibility against rising yields or widening risk premiums, which we believe can outweigh the benefits of greater price appreciation during times of uncertainty.

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