Manage liquidity with bond ladders (Shutterstock)

Using bond ladders to manage liquidity

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As global central banks lay the groundwork for policy easing, we think now is an important time for investors to review their liquidity strategy and ensure their portfolio income streams are durable. Bond ladders can be a useful tool to help investors balance their liquidity needs with stable income generation.

After two years of rising interest rates, global central banks are now laying the groundwork for policy easing. In Switzerland, the rate-cutting cycle is already underway with the Swiss National Bank's 25-basis-point reduction in March. In the US, the Federal Reserve still expects to cut rates by 75bps in 2024—likely starting around midyear, in our view. The European Central Bank, the Bank of Canada, and the Bank of England are all likely to follow suit in the coming months as inflation cools.

This pivot in central bank policy is a key moment for investors, and one that may present a particular risk for those holding excess cash. Today's cash rates still look appealing. But as interest rates fall, cash will progressively deliver lower returns, creating a risk for those who do not proactively manage their holdings.

To prepare portfolios, we think investors should build a liquidity strategy beyond cash and money market funds, and shift toward more durable sources of income. Fixed-term deposits can be used to lock in today's rates and to meet potential expenses and liabilities up to 12 months out. To cover net expected portfolio withdrawals over the next one to three years, investors can consider buying a bond ladder—that is, a series of individual short-duration bonds of varying maturities—staggering their expiry to provide a steady stream of income.

We see three key reasons to invest in a bond ladder as part of a liquidity strategy:

Investors retain the flexibility and liquidity to meet their cash flow needs. As each bond in the ladder matures,

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the principal is returned to the investor, who can use it to meet spending needs (or to take advantage of new investment opportunities). Since the bonds in a ladder mature at different intervals, investors have regular access to their principal without having to sell bonds before maturity, which could result in a loss if sold in an unfavorable market.

Bond ladders can be tailored to meet investors' specific financial plans and liquidity requirements. Investors can decide the number of rungs (individual bonds), the spacing between maturities, and the overall length of the ladder based on their investment goals, risk tolerance, and cash flow needs.

Bond ladders offer a predictable income stream and a way of locking in today's attractive yields. By constructing a ladder, investors can generate a predictable flow of income as the bonds mature in series. The bonds also pay interest at regular intervals (semi-annually or annually), and enable investors to lock in today's attractive yields. The 2-year US Treasury yield currently stands at 4.7%—not far below last October's high of around 5%, and well above the levels that have prevailed for much of the past 15 years.

We see the reinvestment risk from holding cash as greater than the potential gains from waiting for better bond prices, and therefore recommend that investors act soon to lock in yields before central banks cut rates. In our base case, we see the 2-year Treasury yield falling to 3.25% by the end of the year.

Investors can benefit from diversification and risk management. A well-constructed bond ladder can include a

variety of bond types, such as high-quality corporate bonds and government securities. This diversification helps reduce the overall risk of the bond portfolio. Diversifying maturities also helps investors mitigate duration risk, by smoothing out the effects of interest rate changes over time.

Beyond buying individual bonds, investors can consider more actively managed investment approaches that have the flexibility to invest in a diversified, risk-controlled manner.

In summary, bond ladders can be a versatile tool for investors looking to balance sustainable income generation, risk management, and capital preservation. We see bond ladders as a key part of a well-rounded liquidity strategy, along with fixed-term deposits (for expenses over the next year) and structured investment strategies with capital preservation features (for cash intended for use in three to five years' time).

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To read more, please refer to our report: **Fixed Income Strategist: The Slow Turn: Q2 Outlook** 5 April 2024.

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