ViewPoint

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Are Bonds Still a Good Investment?

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Bonds resonate with safety and predictability in the minds of investors. For more than 30 years, that perception has been cemented by the fact that steadily declining interest rates have lifted bond prices, providing bond investors with outsized returns and very little volatility.

Recently, however, bond investors have faced volatility and losses. For the first nine months of 2013, the Barclays U.S. Aggregate Bond Index is down -1.9%, approaching the worst slump in 20 years (1994 : -2.9%).

What happened?

Over the past few months, the U.S. and global economies have showed signs of accelerating growth. As a result, policy makers started discussing measures to renormalize the ultra-low interest rate environment of the last five years — an era that has imposed a severe penalty on savers. The 10-Year Treasury yield responded by rising over 50% (from 1.67% to 2.61%) between April and September 2013, leading to declines in bond prices.

Are rising interest rates just plain bad for bonds?

Conventional wisdom says yes. The reality, however, is more nuanced and depends largely on the investor's time horizon.

Returns from bonds come from two distinct sources: interest payments and changes in prices. Over short periods of time, rising interest rates can lead to a decline in bond value as investors look to equalize the yield of existing low-coupon bonds with the higher yield offered by newly issued bonds. To equalize yields, the price of existing bonds must fall. Over long time periods, however, rising rates lead to better opportunities to invest capital at higher yields, therefore increasing portfolio income levels and offsetting prior drops in prices. For long-term investors, we think that the short-term negative impact of rising interest rates on bond prices carries relatively little importance. Over time, interest payments contribute far more to returns than changes in prices. This means that a slow and gradual rise in interest rates will provide better returns in the long run than would a prolonged period of artificially low interest rates.

Diversification matters

Bonds remain one of the best diversifiers of market risk, since they tend to move in the opposite direction from equities. It is important to understand that bonds and stocks do not compete against each other, they complement each other. They work together in an asset allocation mix to provide investors with the optimal portfolio to meet their goals and needs. Short periods of muted bond returns do not negate the importance of a strategic allocation to bonds in a portfolio.

Unless your investment objective, risk tolerance, or time horizon has changed, there is no reason to significantly alter your strategic asset allocation. History has taught us that it is simply impossible to predict the exact timing and magnitude of movements in interest rates. Therefore, knee-jerk portfolio reactions usually prove to be mistakes, as they only increase transaction costs and often lead to adverse tax

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consequences. However, small portfolio adjustments make sense in order to take advantage of what we think may be a long and gradual rise in interest rates, coupled with bouts of price volatility. This is a process that we started way before the recent rise in interest rates.

Bond strategies in a more complex rate environment

Bonds, like any other investments, carry some risks. The two primary ones are known as "interest rate risk" (also known as duration risk) and "credit risk" (also known as default risk). Interest rate risk refers to the price movement of a bond due to a change in the level of interest rates. Credit risk refers to a loss of principal stemming from the borrower's failure to repay the debt.

Different bonds carry different degrees of interest rate risk and credit risk. As a result, some bonds perform better than others in an environment of rising interest rates. Here are some of the strategies we have implemented to take advantage of the current climate:

1) Favor credit risk over interest rate risk: Accommodative central banks and a generally improving macroeconomic environment are ideal for borrowers as they facilitate the repayment of debt. In addition, credit-sensitive assets generally carry a higher coupon that can help offset principal losses resulting from rising interest rates.

2) Maintain short-duration targets: Short-term bonds are less sensitive to changing interest rates. Also, due to a shorter maturity, proceeds from these bonds can be reinvested into higher-coupon securities more quickly.

3) Explore alternative options: International bonds and convertible bonds offer attractive yields with low correlation to U.S. yields. Senior bank loans are also a compelling addition to fixed-income portfolios, as their floating-rate coupons adjust quickly to rising interest rates.

A few words on municipal bonds

A combination of factors led to a meaningful correction in the muni market during the summer months. As Detroit filed for bankruptcy on July 18th, muni bonds sold off on investor fears, causing yields to rise. The largest municipal bankruptcy in history came at a bad time, as a general rise in interest rates was already affecting the sector.

The $3.7 trillion municipal bond market represents a small subset of the entire fixed-income universe. The muni market is highly fragmented, with more than 90,000 issuers. Issues tend to be small and sometimes illiquid. The investor base is also very homogeneous, with retail investors owning nearly three-quarters of debt outstanding, according to Ned Davis Research. That makes the market more susceptible to irrational, sharp movements driven by headline news.

Detroit's credit rating first fell below investment grade in 1992, so the deterioration of the situation was predictable. Only yield-chasers could justify an exposure to the city. The muni market is not immune to defaults, but the majority of the market remains high-quality, with only a small percentage of the universe rated below investment grade. Defaults are rare, and recovery rates are high.

At Trust Point, our focus has always been on quality first. We avoid issues with weak fundamentals and we monitor credit-rating changes daily to ensure ongoing adherence to our quality standards. We did not own any Detroit munis and have no intention of buying any.

Munis as a group, though, are historically cheap. That makes them especially attractive compared to taxable bonds for investors in high income tax brackets. Despite material improvements in state and local governments' finances over the past few years, munis now trade well above 100% using the after-tax equivalent Muni/Treasury yield ratio (a key valuation metric in the sector). As a result, munis continue to play a key role in our clients' portfolios.

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