Caveat Emptor: The New Bond Market

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While the warning of "buyer beware" has often been applied to sale of real property, investors would be wise to contemplate the phrase in relation to today's bond market. Since the depths of the credit crisis in late 2008, investors have been drawn to bonds' relative stability and income. After all, why would investors want to own money market funds that pay microscopic, if any, income, much less own equities (regardless of their attractive valuations) that entail punishing volatility?

In the 21 months ending September 2010, U.S. investors pulled cash out of money market funds and stock funds and purchased over $560 billion of bond funds. Looking in the rear-view mirror, bond returns certainly have been alluring. In the three years ending September 30, 2010, the Barclays Capital (BC) Aggregate Bond Index, comprised of Treasuries, government agencies, high-quality mortgages and investment-grade corporate bonds, generated an average annual return of 7.43%. Over this same time frame, large cap stocks, as measured by the S&P 500 Index, lost an average of 7.16% per year. The performance spread between these two asset classes was a staggering 14.59% per year.

Realistic Expectations

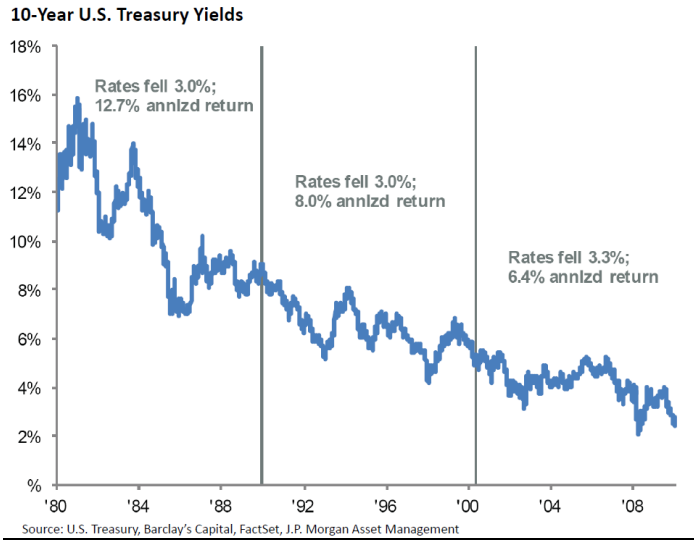
The flood of money into bond funds may indicate that retail investors are neglecting a realistic view of bonds' future returns. Forward returns on bonds are driven primarily by their current coupons, which are near multi-decade lows. Secondary influences on bonds' total returns include changes in the yield curve, the rates at which income is reinvested, changes in spreads, and defaults. While estimating future long-term returns on equities is very challenging due to the myriad of economic, valuation, political and sentiment factors that influence their prices, forecasting returns on investment-grade bonds is much more straightforward, as their future returns are anchored by their current coupons.

As of mid-October 2010, the yield on the BC Aggregate Bond Index was approximately 2.5%, down from 5.75% as recent as mid-2007. Active fixed-income managers may seek to enhance returns above this 2.5% level by yield-curve positioning and rotating between segments of the investment-grade, high-yield and non-U.S. bond markets. Over the long-term, a few fixed-income managers have proven their skill in generating total returns in excess of the BC Aggregate. Nonetheless, investors should expect that the average annual returns on investment-grade bonds over approximately the next five years to be much closer to 3% than the 7.43% annual returns of the last three years.

Why Own Bonds?

With bonds' current coupons at multi-decade lows, some investors may question whether it is worthwhile owning bonds. Historically, diversified investors typically have allocated a portion of their portfolio to fixed-income as an important stabilizing force. The magnitude of returns in down markets is one of the key differentiators between bonds and stocks. For example, the worst 12-month return for U.S. bonds since 1926 was -9.2% ending in March 1980, while the worst 12-month return for U.S. stocks was -67.6% concluding in June 1932. Bonds provide some relative stability, especially in an equity-heavy portfolio. While it is possible for future bear markets in bonds to be worse than the 1979-1980 loss of 9.2%, bonds should not be jettisoned from a portfolio merely because of their low coupons.

In prior environments of relatively low interest rates, some investors have been enticed by higher yields on REITs, utility stocks, junk bonds, real estate properties, master limited partnerships, and other securities. While each of these investments may have an appropriate place in a diversified portfolio, the prudent approach for investors is not to focus on income, but carefully consider each investment's range of potential total returns and the severity and duration of historical losses.



Forecasting Rates

For several years investors have been stating that interest rates "will only go up from here," yet only to see them fall to lower levels. Even the best and brightest U.S. economists have found it challenging to predict the direction of interest rates. Since 1982 *The Wall Street Journal* has conducted a semi-annual survey of economists asking for their expert opinion on whether interest rates would be higher or lower in six months. Consensus estimates from these professionals were incorrect in 36 out of the 55 periods measured, or 65.5% of the time.[1]

Instead of trying to predict the direction of rates over the short-term, investors would benefit more by understanding the major factors that move interest rates and the potential impact of rising rates on their portfolios.

Decomposing Rates

In March 2010, Vanguard published an historical analysis of the major components of the yield on 10-year Treasury bonds.[2] While Vanguard's statistical decomposition is rather complex, their study may be summarized as having identified three primary factors that shape bond yields:

1) The expectation for long-term inflation plus a risk premium.

2) The supply of U.S. government debt, as measured by the structural fiscal deficit.

3) The demand for Treasury bonds from U.S. households and foreign investors.

The first of these three factors has tended to be the most powerful factor in the composition of 10-year yields. In the decade of the 1980s, the average yield on the 10-year Treasury was 10.6%, out of which 6.4% could be attributed to the expectation for inflation plus a risk premium. In calendar year 2009, the expectation for inflation plus a risk premium had fallen to 2.9%, comprising the vast majority of the average 3.3% yield on the 10-year.

In the current environment of high unemployment and sluggish economic growth, inflation is not expected to rise significantly for the next couple of years. At the end of September 2010, the Treasury Inflation Protected Securities (TIPS) market indicated that investors expect inflation over the next 10 years to average a modest 1.8% per year. An unexpected surge in economic growth or commodity prices could put upward pressure on bond coupons. However, as long as expectations for inflation remain modest, bond yields will tend to be anchored at relatively low levels.

The second and third aforementioned factors in Vanguard's study may be summarized as Treasury supply and demand, respectively. While the U.S. government has been flooding the markets with an ever-increasing issuance of debt for sale, so far the demand from U.S. citizens, banks, the Federal Reserve and foreign investors has more than kept pace.

Escalating U.S. debt in the coming years will likely make it more challenging for demand to keep up. Buying power for Treasury bonds is difficult to anticipate, as demand from China, Japan and U.S. households is subject to wide-ranging economic, political, and currency factors. Even modest reductions in total demand could fuel volatility in the bond market and place upward pressure on U.S. interest rates. While the 2008-2009 credit crisis contributed to a sharp decline in Treasury bond yields, the next major unanticipated crisis may not create such an insatiable demand for U.S. government IOUs.

Rising Rates

Even though the yield on the 10-year Treasury has fallen dramatically from its zenith of 15.84% in September 1981, there have been several painful reversals along the path. Increases in the yield on the 10-year during a 13-month period in 1993-1994 resulted in a 10.6% loss, and in a two-month period in 2003 the 10-year yield jumped one percentage point, leading to an 8.2% decline.

Current low yields provide a very thin cushion in a rising interest rate environment. If interest rates on a 10-year Treasury increased from a recent 2.78% to 4.78% in a one-year period, the total return on the bond would be -10.6%. The longer the maturity, the greater the loss; the total return would be -24.4% in a one-year period if the yield on a 30-year Treasury increased by 2.00% to 5.95%. In an environment of low nominal yields, investors need to be vigilant that their portfolios are not exposed to long-duration fixed-income strategies.

While significantly rising interest rates can be quite bitter for bond investors, there is a sweet aftertaste: improved forward-looking returns. All else being equal, investors should consider increasing their allocations to fixed-income when interest rates rise.

Other Considerations

The current bond market environment also calls for consideration of specialty fixed income strategies. Some of these opportunistic managers construct portfolios with minimal sensitivity to changing interest rates and employ relative value strategies, including convertible arbitrage (buying a convertible bond and shorting the related company's equity), capital structure arbitrage (buying long and short positions in different securities of the same firm), and pairs trading (buying and shorting similar securities of different companies). Investors need to carefully weigh the advantages and disadvantages of specialty strategies and restrict them to a minority position of their fixed income allocations.

Another consideration for mitigating portfolio volatility may be the inclusion of conservative hedge fund of funds. Diversification of managers and strategies is essential in this space, and the pros and cons of the products should be thoughtfully considered.

Conclusion

Today's bond investors face challenges that have been rarely encountered over the past 30 years. Realism, prudence and vigilance will be essential for fixed-income investors in the coming years, and Innovest is privileged to partner with its clients in this endeavor.

Footnotes:

1 *The Wall Street Journal* Survey of Economists, updated June 30, 2010. In June 2002 the benchmark changed from the 30-year Treasury to the 10-year Treasury.

2 "Deficits, the Fed and rising interest rates: Implications and considerations for bond investors." March 2010, pp. 8-9. The Vanguard Group, Inc.