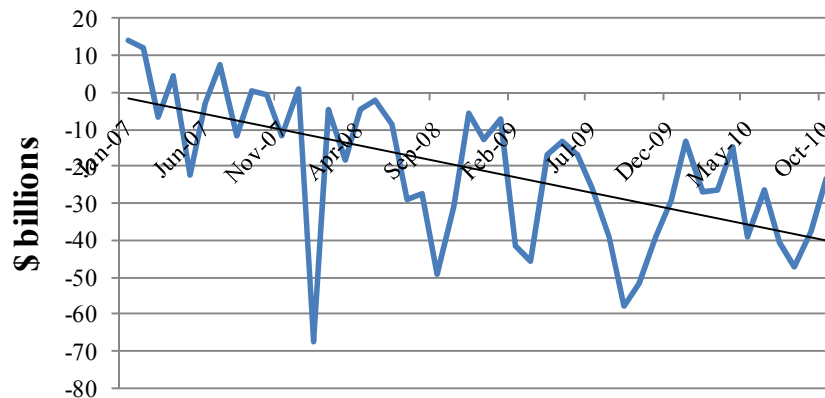




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Over the past 3+ years, investors have been moving out of stocks and into bonds. The graph below shows the difference between flows into stock mutual funds and flows into bond mutual funds:¹

Stock Mutual Fund Flows Less Bond Mutual Fund Flows



In total, investors have pulled a combined \$68 billion *out of* stock mutual funds and put a combined \$146 billion *into* bond mutual funds over the past six months.² On the face of it, this seems logical. The stock market, while not overpriced, is not incredibly cheap and continues to exhibit heightened volatility. Further, despite trailing stock returns over the last 20 years by 3% per annum (6.3% versus 9.3%), bonds have outperformed stocks by nearly 6% per year over the past 10 years (5.5% versus 0.0%).

Yet these reasons don't stand up against investing logic. While bonds still warrant a core position in most investment portfolios, investors need to temper their expectations for returns going forward. Actively overweighting the asset class or taking above average risk in bond portfolios appears misguided. Analysts who believe that bonds can continue their recent outperformance are guilty of looking through the rearview mirror instead of the front windshield. Perhaps the most important lesson to be learned in investing is that markets are mean reverting – what goes up (above average or expected levels) must come down.³ Based upon disciplined and in reality rather straightforward analysis, it is clear that today's bond investor faces a myriad of risks. In the interest of time, we discuss just a few of the more prevalent risks below, leaving aside issues such as credit risk which remain real and present.

The key differences between a bond and a stock are typically:

1. Bond payments (coupons) are set at predetermined rates whereas stock payments (dividends) are not.
2. Bonds are senior to stocks in capital structures (e.g. in the case of a bankruptcy, bondholders are paid before stockholders).

The relative safety of bonds typically leads to lower short-term volatility but also lower long-term returns. Yet depending upon initial conditions (such as those seen in the 1990's), bonds may in fact outperform stocks for a sustained period of time.

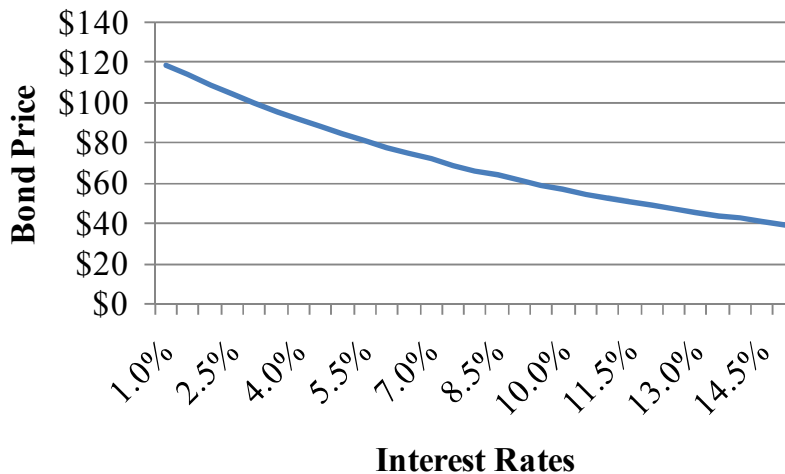
¹ Source: Investment Company Institute.

² From May 2010 through October 2010.

³ Investor Jeremy Grantham of GMO calls mean reversion the "single, big truth." GMO Quarterly Letter October 2008.

The bulk of returns generated by bonds come from two sources: (1) interest and principal payments that occur according to a pre-determined schedule and (2) interim capital appreciation from movements in interest rates. The first source is relatively straightforward – if an investor buys a 10-year bond at 3%, he can expect to earn around 3% if he holds that bond for 10 years. His eventual return will depend upon the interest rates at which he can reinvest his future coupon payments, but it will likely not deviate much from his initial yield (3%).

However, in the interim his return can deviate substantially because of the second main source of returns – movements in interest rates. Suppose that the investor purchases the bond for \$100 when interest rates are at 3%. If interest rates suddenly increase to 5%, his bond must be re-priced so that the new price generates a long-term return of 5% as opposed to 3%. This will necessitate a *drop in the bond's price*. In this case, the price of the bond will fall from \$100 to approximately \$85, a loss of -15%.⁴ On the other hand, if interest rates decrease to 2%, the bond will rise from \$100 to \$109, a gain of 9%. The bond has a **duration** of 8.8, meaning that for each 1% move in interest rates, the bond's price will move by approximately 8.8% in the *opposite direction*. The graph below depicts the bond's price at various levels of interest rates:



The bond's price can experience wide swings if interest rates exhibit high volatility. The longer the bond, the higher the duration, meaning the bond's price will move more for a given change in interest rates. The table below shows the percentage change in price for bonds with different maturities given a 1.0% increase in interest rates:⁵

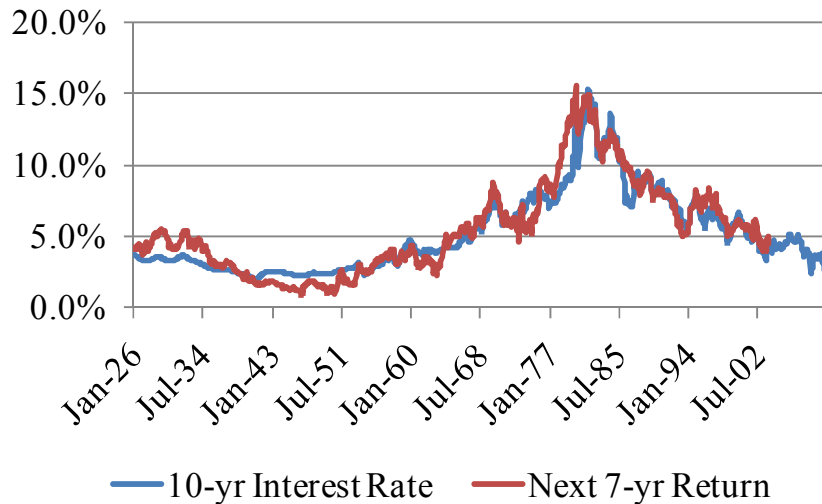
	% Change in Price for 1% Increase in Interest Rates
5-year	-4.5%
10-year	-8.1%
15-year	-11.1%
20-year	-13.6%
25-year	-15.6%
30-year	-17.3%

It is clear to see, then, that the bulk of a bond's returns are determined by (a) the initial level of interest rates and (b) subsequent changes in interest rates. In the case of (a), lower initial interest rates translate into lower potential returns. In the case of (b), the potential for larger future interest rate increases translates into higher risk of capital impairment. These risks are present for all vanilla bond holders, *including those invested in securities guaranteed by the federal government*. The graph below is important

⁴ Assumes annual payments.

⁵ All bonds assumed to be initially priced at par with a 3% yield and annual payments.

for investors to consider. It plots the initial level of interest rates on 10-year government bonds versus the subsequent annual returns realized on intermediate-term government bonds.⁶



It is simple math – it will be incredibly hard for investors to earn returns on bonds anything like those seen in the recent past because of the low current level of interest rates. Bond investing since the early 1980’s has mostly been a one-way joy ride – initial interest rates were high and for the next three decades rates continued to fall. Accordingly, long-term bond investors benefitted from both high initial coupon payments and ongoing capital appreciation due to falling interest rates. But with the current 10-year Treasury rate below 3.0%, there isn’t much room for interest rates to fall further and the risk of an adverse development – of rates going up instead of down for a sustained period of time – is much higher in the current environment.⁷

So far, this discussion has left aside the thorny issue of inflation. Most bonds are priced in nominal terms,⁸ meaning that they will pay predetermined coupons in today’s dollars, **not adjusted for inflation**. In other words, if you buy a 10-year bond yielding 3% and over the subsequent 10 years inflation averages 3%, you will essentially earn nothing *in real terms* on your investment. If inflation averages higher than 3%, you will lose money in real terms. Remember, the investor’s goal should always be to protect and enhance the *real* purchasing power of her assets – in other words, to earn a rate of return on her investments above and beyond the rate of inflation.

So given current rates of interest, investors should leave aside images of past bond market returns on the order of 6-8% and focus more on lower single-digit figures. They must also be cognizant of inflation – if it returns in force, they could very well lose money on an inflation-adjusted basis. So what is an investor to do? We do not believe that the answer is to abandon bonds en masse. Instead, we recommend that investors retain their bond exposure but focus on short- to intermediate-term, high quality bonds and remain patient for better opportunities elsewhere. Most importantly, we feel it is important to avoid stretching for yield at the price of excessive risk.

We are generally avoiding bonds with more than 10 years until maturity. As discussed above, longer-dated bonds are exposed to much more interest rate and inflation risk. We are also focusing on high quality issues, leaving aside risky, lower quality bonds.⁹ The purpose of bonds within a portfolio is to provide stability, liquidity and insurance against a deflationary environment. The primary goal is not to generate outsized or abnormal returns. Accordingly, we don’t think it makes much sense to stretch for an extra 1.0% of yield at the price of a large increase in potential risk. David Swensen, Chief Investment Officer of Yale University, writes:¹⁰

Although under normal circumstances, risky bonds might generate superior returns, investors face likely disappointment in times of financial stress. Buying insurance from a fly-by-night insurance company appears sensible until the unreimbursed

⁶ The red line stops in 2003 because at that point we no longer have subsequent 7-year data to calculate returns. Sources: Robert Shiller and the Federal Reserve.

⁷ There is an asymmetric payoff weighted to the downside – rates can only fall to 0-1% but can rise to 15%+, meaning that the potential upside is small but the downside is large. These kind of asymmetric payoffs make us nervous – we prefer ones where the downside is small and the upside large.

⁸ Treasury Inflation Protected Securities, TIPS, do adjust for inflation and therefore protect the investor from the loss of real purchasing power.

⁹ If we do find a bond that possesses the potential for what we believe to be superior risk-adjusted returns but falls into the low-quality category, we will consider the bond part of our equity or alternative allocation if we decide to purchase it. We will not include it in our core bond portfolio.

¹⁰ Source: Swensen, David. *Pioneering Portfolio Management*, p. 158.

catastrophe losses overwhelm the previous savings from discounted premium payments. When buying an insurance policy, deal only with the highest-quality providers.

We have continued to build our allocation to alternative investments. We have written about this in previous papers and newsletters and believe that the move will prove beneficial to long-term investment results. It should also act to reduce portfolio risk by constructing robust portfolios that protect value in a variety of economic climates. Accordingly, some of this increased allocation to alternatives has come from bonds (as well as stocks).

But while our bond allocation has drifted down, we still remain within our long-term strategic range (though we are in the bottom half of that range). We continue to maintain a target position in bonds because:

- We believe that longer-term, rising rates and inflation represent a real risk, but interest and inflation rates will likely remain subdued shorter-term. We have spent a large amount of time studying the historical precedent witnessed in Japan, where investors have seen rates and inflation stay close to 0% for nearly two decades, despite large domestic debts. We believe that the U.S. situation is not too different – our country is in a liquidity trap with excess capacity, which will act to hold down interest rates and inflation. However, over time we would expect politicians to deal with difficult debt loads by turning to the printing press, which will increase inflationary pressures. This phenomenon will take at least a few years to play out though, over which time we expect to *gradually* reduce our exposure to interest rate and inflation risk.
- While we think that stocks and alternative investments are fairly priced, they are nothing to write home about. We continue to hold quality companies with safe balance sheets that are trading at prices we feel comfortable with, but prices aren't low enough to "double-down." Likewise, alternative investments like real estate and arbitrage are trading in fair ranges that allow us to be comfortable with target allocations, but don't inspire us to go overweight. Therefore, we are happy to retain our core bond positions and cash balances as "dry powder," ready to pounce on opportunities when they arise, which we expect given ongoing volatility in financial markets and continued downside economic risk.

In short, we have not yet made any significant changes to our current investment policies, but are moving at the margin and preparing ourselves to take advantage when opportunities do arise. We will monitor risk in the bond markets and likely shift to shorter bonds over time while retaining our focus on high quality. We will remain at our target allocations for stocks and alternatives, focusing on investments that we believe are selling below intrinsic value and offer above-average quality. We think that high quality is the name of the game here.

Meanwhile, investors should keep in mind that risk is relative. Bonds, even those guaranteed by the federal government, are not "risk-free."¹¹ If interest rates or inflation increase materially, bondholders could be faced with meaningful losses. Likewise, stocks aren't always risky – it all depends on price. At current prices in the bond market – signaled by very low interest rates – it seems hard to generate acceptable risk-adjusted returns buying long-term bonds. If stock prices fall further, they would appear to provide good odds of solid returns over a long-term holding period. For the time being, though, investors should realize that there currently appear to be no "fat-pitches" in the market and remain patient and disciplined, not stretching for risky returns at the price of quality and safety.

For the time being, though, investors should realize that there currently appear to be no "fat-pitches" in the market and remain patient and disciplined, not stretching for risky returns at the price of quality and safety.

¹¹ James Grant, editor of *Grant's Interest Rate Observer*, opined that instead of describing U.S. Treasury bonds as "risk-free return," they should be described as "return-free risk."