

**Recovery: A Double-Edged Sword for Bond Investors**

**This week marks the one-year anniversary of the stock market's plunge to levels not seen since 1997. Last year at this time, the very existence of the Financial System was in question as the Fed, Treasury, Congress, and their counterparts across the globe struggled mightily to craft a recipe for survival of the stock, bond, and credit markets. Central banks met the challenge by lowering interest rates to historic lows and injecting massive amounts of liquidity into the system. For some, those days seem like ancient history. Perhaps that distinction underscores the difference between a Wall Street banker and a retiree living on a fixed income. It's all about perspective. The banks and brokers have returned to profitability and business as usual, not without a substantial assist from taxpayers. The retiree is left wondering how to avoid outliving their income-producing assets in the current low interest rate environment with inflation knocking at the door. History provides a great lesson for them in what not to do.**

We've often been critical of those who believe that past performance is indicative of future results. However, we still take the occasional glance in the rear-view mirror for historical context and clues to what may happen in the future. There are some lessons to be learned. Sadly, after 30 or 40 years, they disappear from the collective memory of the major actors in the Financial System: bankers, brokers, fiscal and monetary policy-makers, and private investors. All of the above had a hand in the collapse of the real estate and stock markets in what is being called the "Great Recession". Of course, the term harkens back to the "Great Depression" of the 1930's. Another version of the same story played out in the 1968-1982 "Stagflation-Inflation" period. All of these periods were preceded by extended economic expansions and record stock market advances. That's where the similarity ends. The 30's stand as an example of a battle lost to deflation. The economy of the 70's, having averted the same fate, was severely challenged by the cure, a crippling form of inflation. The lesson learned by central bankers was that anything is preferable to severe deflation. Today, the outcome isn't assured but they're seeing some success in easing deflationary pressures. Complete success will bring a return of inflation and higher interest rates.

The titles may differ but the story usually goes like this: Act 1. Fostered by easy credit, imprudent fiscal and monetary policy, short-sighted bankers, brilliant financiers, lax regulation, and willing investors, the economy and its markets expand beyond all predictions. They declare "This time it's different". They succumb to the belief that a new era of financial alchemy is upon us, that markets don't go down, and money grows on trees, or in this case, real estate. Act 2. Then.....all markets collapse under the weight of artificially supported asset prices. What follows is chaos, destruction, finger-pointing, and extremely low interest rates. The lesson: the rules of markets can be stretched but not broken. Act 3. A new-found religion emerges, based on oversight, regulation, and a resolve never to repeat these mistakes. The economy moves into a decade-long recovery. Deflation yields to inflationary expectations. Policy-makers shift to an aggressive stance once inflation is deemed to be under control. The markets then confirm a return of economic expansion. Asset valuations rise...and then disengage from reality. Financiers and investors declare "This time it's different". Fade to black.....

Unfortunately, this is a story we are destined to repeat since human nature is at the heart of it. The drama lies in the third act, where the economy hopefully defeats deflation only to then be confronted by a more familiar enemy. Inflation. It's the by-product of a real recovery, a symptom of an overheated economy, and usually triggers a policy response in the form of higher interest rates. It's regarded as a headwind for both the stock and bond markets. We usually discuss inflation in terms of its effect on stocks. Today, we're focused on interest rates and their effect on fixed income investors who will be making decisions today that could have unintended adverse consequences for their portfolios years from now.

## The Yield Trap

We believe the central banks' attempt to inflate the global economy and avert a deflationary spiral in the developed nations will bring about a change in the secular trend in interest rates. The current downward trend in rates began in 1982. Inflation was about to be reined in as the bond market launched into a decades-long bull market. For almost three decades, investors have been paid handsomely to extend maturities out to the farther reaches of the yield curve. They've captured both higher yield *and* price appreciation. Those days are over. With short-term rates near 0%, it doesn't take a rocket scientist to rate the chances for higher interest rates at 100%. Some questions remain: When? How fast? And how far will rates go?

Regardless, this will require fixed income investors to rethink the strategy they've employed for the past 20 years in order to avoid falling into what we call *The Yield Trap*. This can occur when investors, pursuing higher yields, overweight long maturities or long bond funds in their portfolios prior to a major upward shift in interest rates. As you know, interest rates and bond prices are inversely correlated. Higher rates = lower bond prices and vice versa. When rates rise, investors can find themselves "trapped" by a drop in the price of their bonds. The interest they receive can be more than offset by the loss to the portfolio if they have to sell for some reason. Of course, this is of no consequence if they are diversified across a range of maturities and can simply hold the bond until maturity. However, that requires a disciplined approach to positioning fixed-income investments and this is where investors often run into trouble.

Baby-Boomers are beginning to swell the ranks of retirees who, for the most part, are less risk-tolerant and more dependent on the fixed-income component of their portfolios. With the meager returns currently being offered by money market funds and short-term bonds, there is a temptation to pursue higher returns from increased exposure to long-term bonds or bond funds. While many believe investing in bonds reduces portfolio risk, it can actually infuse a higher degree of risk to a portfolio under certain conditions. Aside from professional bond traders and institutions, most investors don't factor price movement into their decision to hold bonds. For them, it's all about the interest rate and safety. When rates are relatively stable and *not* at their historical lows, bond buyers can usually extend the average maturity of their portfolios in the pursuit of yield without seeing their bonds decrease significantly in price prior to maturity. Not so today. Looking back to the mid 70's, we saw many investors, lured by the relatively high yields offered by long term bonds and funds, suffer losses that exceeded those of their stock portfolios over the same period.

## Sidestepping Trouble

While most agree that the return of inflation and higher rates is in our future, there is little consensus as to when that will occur. Regardless of when, there are things to do now. **Number One:** Liquidate or avoid bond funds that hold intermediate or long-term maturities. While yields may currently appear to be attractive relative to short-term investments, there is ongoing erosion of return taking place within the fund. The coupon rate will be "rolled down" as a result of turnover in the portfolio even if rates remain where they are. Reinvesting proceeds from called or maturing bonds will lower the interest payments to shareholders. The current rate of return can only be maintained if the manager takes more credit risk. The real damage to the portfolio occurs when interest rates begin to rise. Since there is no maturity date to the fund, holding those shares is equivalent to buying the same or riskier portfolio of bonds, but with a lower yield in a declining bond market. If you must own a bond fund these days, make sure it's one of *short duration*. There will still be some adverse effects on the portfolio but to a much lesser extent. Money market funds are the best substitute in a rising interest rate environment.

**Number Two:** Diversify bond holdings across the yield curve. Position short-term bonds for liquidity. For longer-term money, extend maturities to capture yield and overweight positions just short of where the curve begins to flatten. Currently, we are positioning no more than 10% of our fixed income allocation in 1 and 2-year maturities. We are overweighting 60% over years 3-5, and placing the remainder in years 6-7. The curve flattens beyond 7 years and provides less incentive to extend beyond that. The longer bonds could show losses as interest rates rise but, absent change in liquidity requirements, they'll be held to maturity and redeemed at par. The shorter maturities will provide not only liquidity but an opportunity to reinvest for higher returns as rates increase.

This approach requires the discipline to just say "No" to the higher yield bonds and products lurking out there. Earning a little less from fixed income now can mean avoiding losses to the portfolio in the future. Unlike the previous three decades, saying yes to those "opportunities" could bring about adverse consequences for those who can least afford it at this time in their lives.