FINANCIAL SERVICES ADVISORY INCORPORATED

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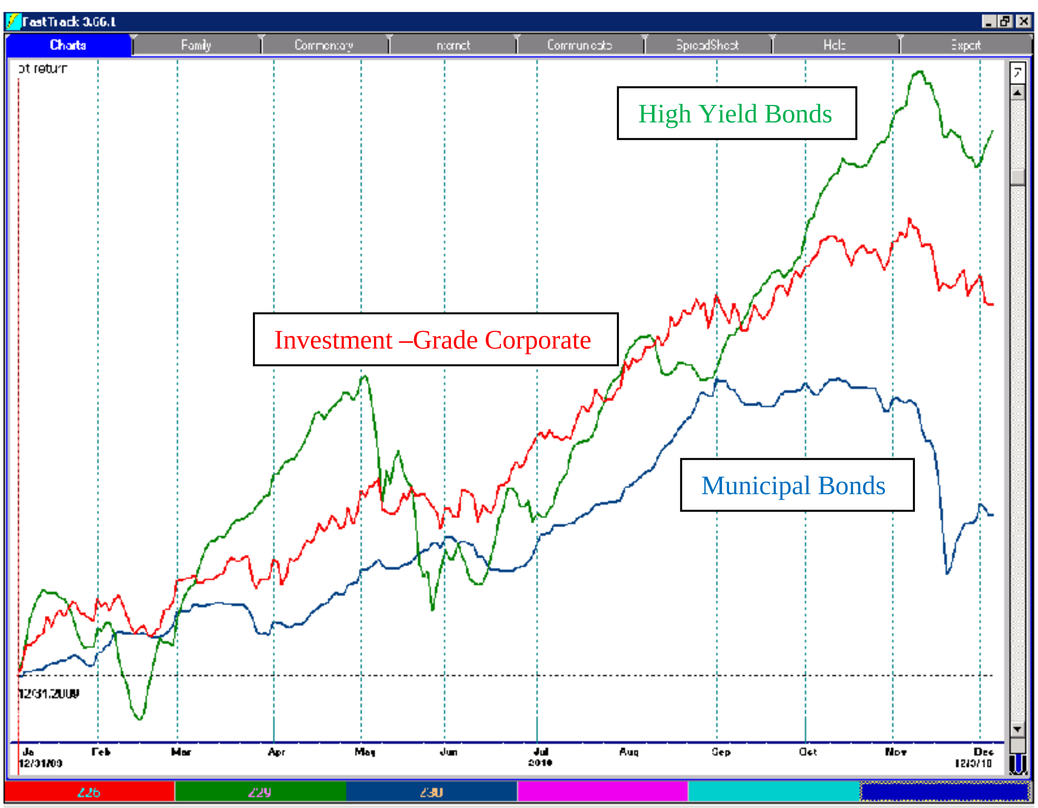
Is the Bond Rally Fizzling Out?

November Market Review From Your Portfolio Management Team—December 9, 2010

As readers of this newsletter know well, we have touted the virtues of bond funds for two years now. And FSA portfolios across the board are heavily invested in this asset class—at least in a number of bond types, including investment-grade corporate, high yield, and tax-free municipal bonds. For the past few years bonds have offered almost a free ride for investors—strong double digit returns minus the volatility inherent in investing in stocks. Through the end of October, there had been over $300 billion of net new flows into various bond mutual funds during the past 12 months, while stock funds had essentially no new net flows (actually a slight negative), which means that investors are not adding to their stock funds this year.

The month of November marked the first time since the markets bottomed in March 2009 that bond funds stumbled while stock funds managed to hold flat or even rise slightly. The chart below shows how the various bond types that we own behaved in November. Municipal bond funds fared the worst, falling 2% - 4%, while the taxable bond funds fell 1% - 2% on average. A few of the municipal funds hit their safety nets and were reduced or eliminated altogether, while the taxable bond funds remain above their safety nets, but we are on watch in case there is any further sell-off.



Source: FastTrack

In spite of all the recent media attention on a bond bubble, we are not convinced that bonds are headed over a cliff, just yet. It has been our experience that once investors have been burned by an investment (stocks suffered two sharp bear markets in ten years), investors are hesitant to go back there for a number of years. That leaves bonds as a natural alternative to stocks. In addition, as the leading edge of the baby boomer generation begins to retire, bonds may continue to receive strong inflows from investors looking for steady income and low volatility.

The concern that many observers have today is twofold:

a) Bond yields are historically low;
b) Policy action by the government and Federal Reserve could be inflationary down the road.

The current yield on the ten-year treasury note is just over 3%. We have not seen yields this low since the fifties, so it is difficult for us today to believe that yields could stay at these levels for very long. However, prior to the sixties, yields typically were in the range of 1% - 3%. As long as the economy remains sluggish, there is no reason to think that yields on government bonds can't remain below 4%.

Government action to spur the economy back to life could have inflationary implications down the road. The government has already spent trillions of dollars and exploded its debt load. Some believe it is the right thing to do to get the economy going, but the concern is how the debt gets repaid. The easiest way to get a government debt load more reasonable is to allow inflation to rise, which in essence makes debts cheaper. So, in these situations, those who make loans (the taxpayers) are hurt while those who receive the loans (the government) get the benefit. This action could cause interest rates to rise, as well as the dollar to fall versus other currencies (from more fiscally responsible countries).

Conclusion

Bonds have had a nice run over the past 2 years, and indeed, bonds have outperformed stocks over the last ten years. We believe there are some powerful secular (long-term) forces that could keep bonds as a favored asset class for some time. Of course, there will be good stretches and bad stretches. Our investment process is to hold our share of these bond funds during the bulk of the good stretches, while our safety nets hopefully get us out during the bulk of the bad stretches. Recently, we are seeing the beginning of what could be a transition period that could bring on a more challenging period for bonds. In a few cases our safety nets have already been triggered, and in other cases, the warning lights are flashing. Since we never know when a small loss will turn into a big loss, we will sell the funds that trip their safety nets, and then decide how best to redeploy the cash.

One of the more unique aspects of investing in mutual funds is that, in December, funds are required to pay out any profits in the form of a distribution. The fund pays the distribution and the price of the fund falls to reflect the distribution. As a result, we will no doubt see a number of fund prices drop this month out of context with what is happening in the bond or stock markets. Already PIMCO Total Return Bond Fund and Rydex Consumer Products have paid year end distributions. We expect we will see others in the coming weeks. Do not be alarmed at these drops in prices, as they merely reflect the payment of a dividend or capital gain to you. This occurrence has not occurred much recently given the negative market environment of the past two years, but as the markets recover, we are seeing more of this occurrence this year.

Finally, we want to thank you for your business and loyalty this year, and we wish you and your families a healthy, happy, and safe holiday season.