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The End of Bonds?

April Market Review From Your Portfolio Management Team—May 12, 2011

Bonds are certainly getting a good deal of negative press these days. After being hailed as a safe alternative for investors in the aftermath of the Financial Crisis, which encouraged over $600 billion to flow there during 2008 – 2010, it seems as though everyone now believes this investment class is ready for a tumble.

Unfortunately, the media often simplifies its stories by painting with a very broad brush, which in this case means they are treating all bonds as being the same. Well, the bond market is incredibly large (over $30 trillion just in the U.S.) with a huge array of types and sub-categories, just as we see with the stock market. There are long-term bonds and short-term bonds; there are bonds of high quality and bonds of low quality; there are domestic bonds and foreign bonds; and taxable bonds and tax-free bonds.

The primary concerns that most experts have with bonds is threefold:

1) Bond yields are near historical low levels
2) The huge federal deficit and debt of the U.S. government calls into question our creditworthiness
3) A great deal of money has flowed into bonds in recent years which could stampede out if/when interest rates begin to go up

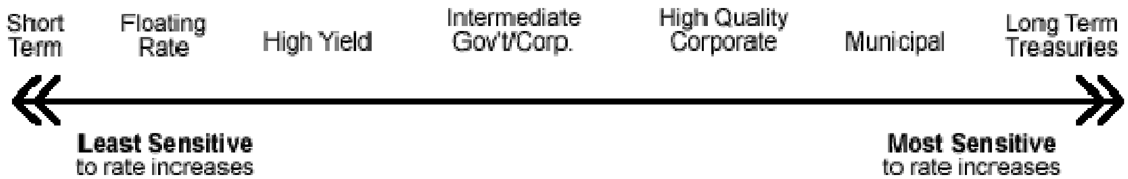
Most analysts, who warn of troubles coming to the bond market, are primarily referring to Treasury bonds which are issued by the U.S. government. These bonds are considered the safest in the world and therefore, they tend to yield the lowest of any bond type. They are also the most sensitive to changes in interest rates, which is one of the main reasons they are a pariah among most market commentators.

Bond prices tend to move in the opposite direction as the level of interest rates. Think of it like a see-saw, with prices on one end and interest rates on the other. If interest rates go up, then prices must go down and vice versa. So, what types of bonds are most affected by rising interest rates? Bonds with longer maturities are more affected than shorter maturities. For example, a bond that matures in 15 years will be more negatively impacted by rising rates than a 3-year bond.

Also, the higher the credit quality of the bond, the more it will be affected by rising interest rates As a result, so-called junk bonds (issued by smaller or less creditworthy companies) will generally not be as impacted by rising interest rates as bonds issued by solid stable companies like IBM or GE. The most creditworthy issuer of bonds is the U.S. government, which is why they are quite sensitive to rising interest rates.

What about foreign bonds? Their performance is driven by what is going on in their home country, so it is possible that interest rates could be rising in the U.S. but falling in other countries.

The chart below illustrates which bonds are most affected by rising interest rates and which ones are less affected. In general, short-term bond funds and lower credit quality bond funds are not heavily impacted by rising interest rates.



What Does This Mean For Clients of FSA?

For conservative investors, this concern over bonds raises two issues:

1) Why does FSA remain so heavily invested in bond funds given all the negative press out there?
2) How can a conservative investor make money in a safe and consistent way if bonds are a bad investment?

1) As you know, we invest where we see the best low-risk opportunities until the environment changes or until the FSA Safety Nets™ are triggered. Even though it has been a choppy environment over the past 6 months, most areas of the bond market remain quite strong. The chart on the following page illustrates that while there has been a noticeable separation of performance over the past 6 months, most areas of the bond market continue to trend in a consistent and positive direction (especially over the past month or so). So, in spite of alarming headlines concerning bonds, at this point, they continue to be a good investment for conservative clients.

   In addition, we are generally staying away from the most vulnerable area of the bond market—U.S. Treasury bonds. We are concentrating our investments in intermediate-term corporate bond funds, as well as high yield bond funds and floating rate funds. These areas of the bond market are not as influenced by rising rates as other areas of the bond market. As always, we have our safety nets in place to sell any bond fund that drops below our exit price.

2) This is a tougher question to answer. Fortunately, the investing universe continues to grow. Funds that were not available 10 years ago can now be purchased. This gives us the ability to own funds that are not so negatively impacted by rising interest rates, including high yield bonds, floating rate funds, as well as intermediate- and short-term bond funds. Finally, we continue to research newer funds with eclectic strategies that are designed to potentially profit regardless of the direction of interest rates, and we will add those to the portfolios, as needed.

   Bottom Line: We have many options available to create a conservative portfolio that is not tied too directly to the direction of interest rates.

High
Yield

Floating
Rate

Corporate

Treasury

Muni