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Bonds are boring but can be a secure bet in uncertain times

VIEWPOINT
Mark Armbruster

I've said it before: No one likes bonds. They're boring, they don't have much opportunity to appreciate in value, they can be rather complicated and their income is generally subject to unfavorable tax rates. Yes, there is a subset of investment geeks who like bonds, who revel in the mathematical complexity of things like duration measures and the negative convexity of the mortgage bond market. For most people, however, bonds are simply a necessary evil.

In today's low-interest-rate environment, the income bonds produce has dwindled significantly. Intermediate-term Treasury bonds generally pay interest that is below the rate of long-term inflation. You also have the risks of rising interest rates and future inflation.

Increasingly, I am asked why we bother to hold bonds at all. The answer, of course, is risk control. While bonds may be tough to love, they do have a place in most investors' portfolios as a hedge against stock market declines.

Bonds' more likable cousins, stocks, allow for significant growth, but they also have a nasty habit of losing lots of value at inopportune moments. Most investors wouldn't be able to take the risk of an all-stock portfolio. Accordingly, a balanced approach that incorporates stocks for growth and bonds for stability is warranted.

Clearly, not everyone agrees. Bond mutual funds saw record outflows of $86 billion in 2013, showing they are out of favor, at best. Investors are dumping bonds because they are producing scant income and are subject to further losses if interest rates and inflation rise.

Let's discuss these risks. Rising interest rates are the most obvious: When interest rates rise, bond prices fall. Last year, the rate on the 10-year Treasury bond rose from around 1.85 percent to over 3 percent at year-end. Consequently, bond prices declined. The income bonds produce can offset this capital deterioration, but because bond yields are so paltry, the total return for the overall bond market was still a loss of about 2 percent in 2013. Investors never like to lose money, but that is particularly true when they are invested in "safe" vehicles.

Inflation is another concern. If your bond portfolio is providing income at a fixed rate of 4 percent but inflation is 5 percent, you are losing purchasing power. You may be earning money in nominal terms, but you are a bit worse off each year because of rising costs. Thus, bonds tend to sell off when there is a threat of inflation. While interest rates have been low recently and inflation has been subdued, there are those who believe both could skyrocket over the coming years. This has many bond investors unnerved.

Another risk is the possibility of your bonds defaulting. This happens when the issuer goes bankrupt. Unlike inflation and interest rate risk, which are systemic, default risk can largely be mitigated through diversification and proper portfolio construction.

Despite these risks, bonds are generally thought of as safer investments because they do not fluctuate in value as much as stocks. Bond prices do ebb and flow, however. For an investor holding a bond until maturity, price fluctuations are largely academic, but they do have an impact on the current value of a portfolio. During the worst of times, back in the high inflation of 1979 and 1980, the Barclays Aggregate Bond Index lost 12.7 percent in just eight months. Longer-term bonds, with even greater sensitivity to interest rate fluctuations, fell even more.

Those are steep losses for bonds. Within just a couple of months, however, bonds recouped their losses and made new highs, at least in nominal terms. After factoring in inflation, the recovery was much longer, particularly since inflation topped double digits back then.

So bonds are paying very little in income currently, and they pose the risk of significant loss. But when the stock market declines, particularly in a really nasty way, bonds tend to shine. In 2008, the stock market fell 37 percent, but the overall bond market rose 5.2 percent. In most portfolios, that wouldn't offset the losses of the stock market, but it would provide a stable portion of your portfolio from which you could draw money if you needed it.

Accordingly, I believe bonds are a core component of most investment portfolios. But with today's low interest rates, many investors are ignoring these benefits. Rather, they are searching for higher yields in places like real estate investment trusts, dividend-paying stocks, high-yield (junk) bonds and other higher-risk investments. All of these outperformed the bond market in 2013, and they generally pay higher rates of income than what you can get from a conservative, high-quality bond portfolio. But by investing in these other asset classes, you are overriding bonds' primary benefit of risk control.

During the financial crisis in 2008, though the total bond market rose, dividend-paying stocks generally posted losses in the range of 20 to 40 percent, publicly traded real estate investment trusts were down roughly 40 percent, and high-yield bonds declined about 30 percent.

Sure, inflation and rising interest rates are a concern, but they are not reasons to avoid bonds altogether; they are merely reasons to tailor your bond exposure. You can shorten the duration of your portfolio so you are not affected as much by interest rate moves. You can also include inflation-protected bonds, or TIPS, to help offset the impact of rising price levels.

The message is clear: While bonds may be boring, they are your surest bet for security during times of economic and stock market uncertainty. Because adverse market conditions are largely unpredictable, it is always best to have an allocation in safer investments, including high-quality bonds. While 2013 was not a great year for bonds, with the recent volatility in the stock market, 2014 may be a year when we are grateful for some more staid bond exposure.

Mark Armbruster is president of Armbruster Capital Management Inc.

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