

Quiz Time

OK class, it's time for this month's quiz. This will count in your final grade. According to the National Center for Health Statistics, the record number of annual births in US history (4,317,119) occurred in what year?

Bonds For The Long Run?

Everyone was shell shocked by last year's stock market decline and when the dust settled US Treasury and high quality corporate bonds were the only assets left standing. Many recent articles have touted the merits of bonds and a popular new book is championing the virtues of an all bond portfolio. The largest poster in the window of my neighborhood Edward Jones office is proclaiming bond yields. Someone must be paying attention because the Investment Company Institute reports that since the beginning of 2009 America's investors have withdrawn \$45 billion from stock mutual funds and invested \$68 billion in bond mutual funds. Taken together, these must be the closest things to an email from God to buy stocks - but that's a subject for another day.

One of the reasons I dislike self-directed retirement accounts is that I haven't met 1 person in 10 who can explain to me the difference between stocks and bonds. And I haven't met 1 person in 20 who can tell me how bonds are priced. Therefore, individuals are investing their money without the basic knowledge required to understand the consequences of their decisions. Most are sure to fail in their attempt to accumulate a nest egg sufficient to last a 30 year retirement. So let me light a candle in the darkness by reviewing some bond basics.

A bond is a negotiable instrument that describes an agreement between a borrower and a lender in which the lender receives periodic interest payments and repayment of principal in full on a stipulated date. Most bonds that individual investors purchase are issued by corporations, municipalities, the federal government, or agencies of the federal government. The document that spells out the terms of the agreement between the issuer and the lender is called the *indenture*. Most bonds have a *face value* of \$1000. A bond that is priced at its face value is said to be trading at *par*. A specified annual interest rate payable to the bondholder, as printed on the bond, is called the *coupon rate*. The bond's annual interest payment divided by the current price of the bond is called the *current yield*.

Bond owners face two primary financial risks -

- The first is *credit risk*. This refers to the potential of the issuer of the bond to default and fail to pay interest or principal or both. The credit risk of a particular bond can be gauged by examining ratings (AAA, AA, A, BBB etc.) given by commercial rating agencies such as Standard & Poor's, Moody's, and Fitch. Higher rated bonds with very little default potential are called *investment grade* bonds. Lower rated bonds, with a higher potential for default, are called *high yield* (or *junk*) bonds. Bonds issued by the United States Treasury are considered to have no credit risk.
- The second risk is known as *interest rate risk*. This is the risk that the price of a bond will fall when interest rates rise. With today's very low interest rates, interest rate risk will be a concern for all bond owners in the years ahead.

Bonds prices can change on a daily basis. Absent a change in the bond's credit rating, almost all variations in price are caused by changes in interest rates. Since bonds pay a fixed amount of annual interest until maturity, a bond's price will rise or decline when new comparable quality bonds are issued at a higher or lower coupon rate. When interest rates rise, prices of existing bonds decline. When interest rates decline, prices of existing bonds rise. Consider the following example -

I purchase a \$1,000 bond, which matures in 20 years and pays 5% interest (\$50) annually.

- If interest rates fall to 4.75% a comparable newly issued bond will only pay \$47.50 in annual interest. I won't sell my bond (and its \$50 annual interest payment) for \$1,000, but I'll sell it at a premium. My bond would rise in price to \$1,031 in order to provide the buyer a current yield of 4.75%.
- If interest rates rise to 5.25%, you would be silly to pay \$1,000 for my bond, since you could buy a newly issued bond that pays annual interest of \$52.50. My bond would fall in price to \$969 in order to provide you a current yield of 5.25%.

These changes in price can be easily calculated using a standard financial calculator.

This interest rate risk cannot be diversified away. In essence, high quality bonds are almost commodities -- those with the same maturity and same high credit rating are good substitutes for one another and will be similarly priced. Therefore diversification among high credit quality bonds is not as important as diversification in stock holdings. However, if a portfolio holds lower quality bonds the need for diversification becomes paramount.

The easiest way for an investor to own a diversified portfolio of bonds is through mutual funds or exchange traded funds. And just like with stock funds, investors have to decide if they want to own a fund that tracks a bond index or pay extra for active management in the hope of outperforming current bond yields. As I have mentioned many times in this newsletter, the evidence for the underperformance of active management in stock funds is overwhelming. Does the same hold true for bond funds?

As long as the credit quality of the issuer has not changed, bond pricing is determined chiefly by changes in interest rates. Therefore, AAA rated bonds of two blue-chip companies with the same maturity date and same interest rate should be priced the same. Only the fear of default or downgrade in credit rating can upset this pricing structure. Consequently, bond prices are much more stable and have significantly less volatility than the stock price of the issuing company. As difficult as it is for active managers to add value when it comes to equity investing, it is much harder for them to add value by bond selection - especially if we restrict holdings to the highest investment grades.

However, bond fund managers are often willing to tap into lower quality issues to boost performance. During years when junk-bond defaults are low -- such as in 2004, 2005, and 2006, this strategy helped boost fund performance and camouflage the additional risk. Only those paying close attention understood the reason for the higher yields. But last year the strategy of exchanging quality for higher yield was a recipe for disaster as the price and liquidity of noninvestment grade bonds plummeted. Bond funds whose managers chased yield by lowering bond quality suffered significant losses.

Oregon's Attorney General has filed a lawsuit against OppenheimerFunds, program manager of that state's 529 college savings plan. The state claims that its 529 investors lost \$36 million in the OppenheimerFunds' Core Bond Fund -- a supposedly conservative investment. The fund lost 36% of its value last year (compared to a 5% gain in its benchmark Aggregate Bond Index). Oregon claims that the fund took "extreme risks in a search for speculative large returns." In a letter sent to investors in Oregon's 529 plan last month, the state Treasurer said that OppenheimerFunds "was not acting in the best interests of participants in the Oregon plan." He went on to accuse the company of "breach of contract and fiduciary duty, negligence, misrepresentation and violation of the Oregon Securities Law."

A question I have been asked lately is "What's going on with the bond funds in the UAL pilots' PDAP?" Their performance in 2008 was pathetic. The Short-Term Bond fund underperformed its benchmark index by 6% (0.5% vs. 6.6%). The Diversified Bond fund underperformed its benchmark index by 8% (-3.0% vs. +5.2%). As the prospectus explains, managers can invest in other than investment grade US securities in a search for higher yield. The managers can purchase foreign bonds when rates are higher overseas but this adds the additional risk of currency exchange-rate fluctuations. In the last few years it has been common for bond funds to seek additional yield by owning emerging market bonds - which adds the additional risk of political instability. In 2008, none of these strategies worked and both PDAP bond funds suffered large and unnecessary losses. As of March 31, both funds have underperformed their benchmark indexes the past 1, 3, and 5 years. The Diversified Bond fund has also underperformed its benchmark index the past 10 years. The Short-Term Bond fund has outperformed its benchmark index in the 10-year period by all of 0.06%. For you baseball fans out there, that's a 1 for 8 - not good enough to keep any hitter in the Major Leagues. A

remarkably bad 2008 has essentially ruined the performance of both funds for the past decade. This should be embarrassing but don't expect Russell to issue a mea culpa, since they know that most of us have no idea what's been going on under the covers of these funds.

Bond fund performance is closely (and inversely) related to fund expenses. This explains why low-cost bond index funds have been able to achieve superior performance versus active management. In 2008, the exchange traded bond fund AGG, (which tracks the Aggregate Bond Index) outperformed 92% of all actively managed taxable bond funds. This was not an anomaly. Bond index funds consistently outperform the overwhelming majority of actively managed bond funds year after year, across many sectors.

U.S. Treasury bonds are all AAA rated because they are considered to be free from default risk but are still subject to interest rate risk. Paying for active management in a U.S. Treasury bond fund is like lighting a cigar with a \$50 bill but not nearly as much fun.

For those investors still in the accumulation phase of life, the primary reasons to own fixed-income investments are to reduce the overall risk of their portfolio and provide a stable cash reserve. For those in retirement, an additional reason to own bonds is to provide a steady cash flow. Owning bonds for any of these reasons and then taking extra risk to enhance yield is, in my opinion, a foolish strategy.

In 1980, annual inflation was more than 12% and 30 year Treasuries were yielding 15%. Declining inflation and interest rates in the years 1985 through 2002 produced one of the greatest bond bull markets in history. But a repeat performance in the next 30 years is unlikely. Unlike the early 1980s, today's interest rates are historically low. Today's yield for the 30 year Treasury bond is 4.1% and inflation is essentially zero. A sustained period of deflation would work well for bond owners but that doesn't appear to be a very likely prospect. If inflation starts heating up as a result of the fiscal stimulus that is now being injected into our economy, interest rates will rise and bond prices must decline.

An appropriate allocation to high-quality bonds is an important ingredient in any portfolio. But an all bond portfolio doesn't make any more sense today than an all stock portfolio did in 2006. In preparing for whatever the future may bring, proper diversification, not buying more of what worked in the recent past, will most likely prove to be the best strategy.

Quiz Answer

There were 4,317,119 births in the United States in 2007, the last year for which data is available. This eclipsed the former record set in 1957 at the height of the baby boom. The birth rate was higher in 1957, since the population was considerably smaller, but the absolute number of births reached an all time high in 2007.

Demographically, we have been conditioned to believe that the baby boom generation was a "pig in the python" because of the bulge it made in the population graph. But rather than a demographic bump, the baby boom was the first stage of a rapid population expansion. Today's US population of 310 million is expected to rise to 405 million by 2040 - a 30% increase in 30 years.

In the future there will be more people in the workforce and baby boomers will be working longer. Consumer demand - as measured by SPB (Stuff People Buy) will continue to rise as more goods and services are needed by our growing population. And the economy will continue to expand.

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