Registered Investment Advisor Firm

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My Name is BOND

Do you like your taxes shaken or stirred?

Welcome to April, the most taxing month of the year (sorry – I couldn't resist).

This is the time of the year that we tend to pay the greatest attention to all things financial in our lives, whether we do it ourselves or outsource it to a tax professional.

This past March 9th, stocks celebrated their 6th birthday since the bottom of 2009. For many this seems like a long time and I would suggest it's really a matter of perspective related to your time horizon and investment goals.

That said, 6 years can be considered a significant period of time, and sufficient enough for many to question its sustainability going forward, especially when we find ourselves on the cusp of the Fed threatening to finally raise interest rates from their historic lows.

But when we consider the 6 year bull-run by stocks and compare it to their cousin – the bond, we can see that for the past 35 years long-term rates have fallen from a high of 15% in 1981 to where they are today.

Rates fall when bond prices rise, so if the stock bull-run has been impressive, what do you call the bond "bull-run?"

The Barclays U.S. Aggregate Bond Index has posted a negative return in just three calendar years since 1980. Many investors feel bonds never lose money, and depending on how you own them (outright held to maturity or through a mutual fund or ETF) it's a fair belief, but still wrong. While there have been losses, those losses were really small: 3% in 1994, less than 1% in 1999, and 2% in 2013.

Complacency is not your friend at this stage of the pending rate cycle. If you're one of those investors that knows a fair amount about how bonds react in a raising rate environment – congratulations!

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If you own a bond outright, you're probably someone with a plan to hold it until maturity and be paid back 100% of your principal investment. Hopefully you invested in a bond that out-paced inflation so your real rate of return is a positive number.

Bond-fund investors might need to dig a little deeper to gain the knowledge of the risks that could lurk within their portfolios.

If you're sitting in a dark room, turn on a light, I don't want you to become overly frightened.

Unlike cash which stays the same throughout market cycles, the answer isn't to exclude bonds from your portfolio entirely, as high-quality bonds can serve as a counterbalance to volatility. Bonds could even gain value when stocks take a fall.

But because we appear to be on the verge of a period of rising interest rates, you may want to conduct your own due-diligence if you manage your own portfolio.

Because bonds have had it so good for so long, looking to past performance will not be of much value. Remember as rates rise, bond prices tend to fall.

Thus a more practical way to examine your options might be to look at specific periods of time and market conditions to discover how fixed income products faired or reacted in those environments.

Let's start with **2008** as performance during this "bear-market" year provides a good gauge for the risky performance of equity funds, alongside a good portrayal of both the economic sensitivity and liquidity of bond funds.

If you owned lower-quality bonds in 2008, you probably suffered losses on par with equities in some cases. If so, this could be a good indicator that your fund owned a significant percentage of "high-yield" or "junk" bonds in its portfolio. While this may be true, correlations aren't absolute because even multi-sector, bank-loan, or non-traditional-bond categories had a difficult year due to oversized exposure to lower-rated corporate or mortgage-backed bonds.

That year also proved challenging for high-quality but less-liquid bond types such as Treasury Inflation-Protected Securities (TIPS) and municipal bonds due to large forced sales at depressed prices.

The second quarter of **2013** punished funds that were sensitive to interest-rate changes.

The Barclays U.S. Aggregate Bond Index lost 2.3% during the quarter, whereas more rate-sensitive bond types lost considerably more than that.

For example, on average long-term Treasury funds lost 6% during that three-month period, and the typical TIPS lost just about as much.

If you're concerned about how your fund will behave in a rising-rate environment, examining its performance during this time period, and comparing it with its

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category peers, can help you to anticipate what you might expect.

Looking to your fund's portfolio will provide the best forward-looking view of the risks that could wait in its future.

Unfortunately, these updates frequently have a 3 month lag as mutual funds usually publically update their holdings once a quarter. If that's a concern, you might look to an ETF that updates daily.

When you examine the fund's portfolio, you will want to pay attention to such metrics like:

1. **Duration:** For high-quality bond funds, duration can provide a quick way to assess how interest-rate changes are likely to affect a portfolio. A general rule of thumb to consider is that a fund will lose roughly as much as its duration in a one-year period in which rates trend up 1%. What this doesn't take into consideration is that for short duration bonds, you also benefit slightly because the yield itself ticks higher when rates go up.

2. **Credit Quality:** As yields have dropped lower over the past several years, many funds have dropped down the credit-quality hierarchy in an effort to boost their payouts and attract investors. The economy has strengthened, and with it the prices of lower-quality bonds rose as well. Flip it and look at the opposite scenario where rising rates in a slowing economy will tend to be challenging for lower-quality bonds and can lead to real losses. There are many core-type short- and intermediate-term bond funds that have specific limits surrounding how much they can invest in true high-yield bonds rated BB and below. Such bond funds will tend to fare worse than AA and AAA rated bonds in a flight to quality like we experienced in 2008.

3. **Yield:** Because the yields produced by fixed income investments have fallen to current levels, it's natural that many investors shop for bond funds based on their yields. But what they might not consider is the connection between a higher yield and higher risk. Of course, some funds deliver higher yields than their peers because their expenses are lower, but in the absence of low expenses, a higher yield relative to other bonds in the same category will tend to indicate extra risk-taking.

To help you assess what category medians might be as a good benchmark to compare your bond fund or one you're considering, here are SEC yields for a few bond categories as of this writing (each carries a different level of risk):

Intermediate-Term Bond: 1.73%
Short-Term Bond: 0.67%
Bank-Loan: 3.29%
Multi-Sector Bond: 3.10

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Nontraditional Bond: 1.30%
Muni-National Intermediate: 0.89%

Answer Forum

I obviously did great job of explaining everything as no one had any questions or issues this past month. ☺

Davis Investment Group

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States.

Davis Investment Group custodies all client assets at Charles Schwab & Co. Davis Investment Group's home office is located at 714 Marin Street, Suite #C, Vallejo, CA 94590. The telephone number is (707) 648-2024.

If you have questions or would like further information on this month's topics or any other financial or investment related subjects, including Social Security claiming strategies, please contact me directly at (925) 360-6819 or through my email address at: Bud@DavisInvestmentGroup.biz

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