DAVIS INVESTMENT GROUP

# Registered Investment Advisor Firm

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## REDUCING BOND RISK

I think by now everyone knows that the interest rates have been declining for 30 years and low interest rates over the last 8 years. This means savers have been punished with lower and lower yields- roughly zero in a typical bank savings account- and investors have seen their capital increase.

Rates are beginning to rise and more is planned. Investment strategies in the past will not work as well in the future. To understand, as interest rates go up, prices of bonds must fall and conversely as interest rates go down, prices of bonds must rise. As an example, if you owned a 2% $1,000 bond, you would receive $20 per year. If rates go up to 2.5%, a new $1,000 bondholder would receive $25 per year. To equalize the bonds, the 2% bond price would need to fall to $800 so that the $20 payout on the older bond equals the current 2.5% rate.

How can investors protect themselves? There are several strategies to offset future declines.

One strategy is to buy individual bonds instead of bond funds. These bonds have maturity dates and must be redeemed for their face value. If you hold onto that $1,000 bond until it matures, you will get your full $1,000 back; bond funds cannot make that same claim. You will temporarily show losses, but you will get your money back. For that reason, individual bonds never fall all the way to the price that rising rates would suggest, and rise faster as they get closer to maturity. Thus longer-term bonds have a much higher interest-rate risk exposure than shorter-term bonds, and that exposure can lead to a decline in a portfolio's value.

Bonds with the longest maturities typically pay the highest rates. For this reason when rates rise, the value declines more than shorter maturities. Another strategy is to utilize short to intermediate (3 to 7 year maturity) bonds or bond funds. If rates rise by 1%, a short-term bond may lose about 3% of its value, while a long-term bond may lose 15%.

Another strategy is to use a barbell approach. Balance the allocation so that short-term and long-term bonds are equal and rebalance annually. This will smooth out the impact.

An investor can buy Treasury Inflation-Protected Securities (TIPS). These bonds have a relatively low yield, but their principal value rises in lockstep with inflation (rising interest rates are associated with inflation). These bonds can be purchased individually, or in open-ended mutual funds (MF), the protection is the same.

Buying bond-like stocks is yet another way to hedge against interest-rate risk. They are often in heavily regulated industries (such as telecomm, electricity and banks) and grow slowly, but distribute profits as healthy dividends. They were referred to as "widow and orphan" stocks. Many still pay fat dividends and in recent years have been yielding higher than those of bond coupons. Again, there are MF and Exchange-Traded Mutual Fund (ETF) that follow this strategy.

Another stock type strategy is the use of preferred securities. These are stock assets but pay out a higher yield than common shares and usually have higher yields than investment-grade bonds. Preferred shares must payout before dividends are paid to common shareholders. Preferred stocks combine the feature of debt, in that it pays fixed dividends, and equity, in that it has the potential to appreciate in price. Again these are available as individual shares, MFs or ETFs.

Convertible securities is another strategy. A convertible security is an investment that can be changed into another form. Common convertibles are convertible bonds or convertible preferred stock, which can be changed into equity or common stock. A convertible security pays a periodic fixed amount as a coupon payment (convertible bonds) or a preferred dividend (convertible preferred stock), and it specifies the price at which it can be converted into common stock. These are available in MFs and ETFs.

Real Estate Investment Trust (REIT) is another strategy to reduce bond risk and also diversify your portfolio at the same time. A REIT is a type of security that invests in real estate through property or mortgages and often trades on major exchanges like a stock. REITs provide investors with an extremely liquid stake in real estate. They receive a special tax consideration and typically offer higher dividend yields. REITs are comparable to mutual funds, allowing both small and large investors to acquire ownership in real estate ventures, own and/or operate commercial properties such as apartment complexes, hospitals, office buildings, timberland, warehouses, hotels and shopping malls. REITs are required by law to maintain dividend payout ratios of at least 90%, making them a favorite of income-seeking investors. The three types of REITs are equity, mortgage and hybrid (a combination of equity and mortgage). REITs provide a liquid and non-capital intensive way to invest in real estate. Many have dividend yields in excess of 10% and are largely uncorrelated with stocks and bonds, meaning they provide a measure of diversification.

If you need more information, or if these strategies are suitable for your accounts, contact me so we can discuss.

*FED Watch*

No change in rates as of the last meeting. However, the language used by the FED indicates rates will rise soon and projecting to raise three more times in 2017.

Market observers give a 40% chance of a quarter point rise in the Fed Funds at the next meeting.

The next meeting is March $14^{th}$ and $15^{th}$.

## 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 by phone or through my email address at:
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