Manager Perspective

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TANDEM
WEALTH ADVISORS

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Do Bonds Still Serve a Purpose in My Portfolio?

During the past several months, we have gotten a number of questions regarding fixed income (bonds). One client called us after a popular personal finance guru on TV told viewers they "should be getting out of bond mutual funds..." Another told us friends were being advised by their advisor to scale back on their bonds. Many investors are concerned after the sharp spike in interest rates (and concurrent decline in prices of bonds) in 2013. Fixed income markets have been turbulent since May, when the Federal Reserve first spoke of an eventual reduction in quantitative easing (QE).

We want to provide some clarity because we believe investors must know that the question is not whether one should or should not own bonds, or should own fewer bonds. Rather, it is about what types of bonds to own as rates rise. Further, we wish to explain why bonds deserve a place in all investors' portfolios and what we expect from bonds over the next few years.

First, we believe investors need to hold bonds as part of their total portfolio even when interest rates are rising. Bonds provide stability, diversification and reduce volatility in any portfolio. Bonds are an important part of a well-constructed portfolio. Although the Fed has not yet altered its QE program – and has stated that it expects to maintain the near-zero policy rate until 2016 – investor confidence in bonds remains shaken. One concern relates to low current interest rates. Investors wonder if returns are going to be low on bonds during the next few years. The answer is a resounding yes. If rates stay where they are, you will collect a very low coupon yield. That is essentially the best-case scenario. If yields rise from here, you may see lower total returns or even negative returns, depending on the amount interest rates rise and the duration (maturity) of your bond holdings. With that as the backdrop, many are wondering why they should continue to hold bonds at all.

Tandem recommends that investors maintain a well-diversified investment portfolio consisting of bonds, stocks and cash. The percentages for each asset class are determined on an individual basis taking into account each client's unique objectives, age, income and other variables. We firmly believe that there is a place and a purpose for bonds in every portfolio even if that investment produced a

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negative real return over ten years. The primary reason for owning bonds is to serve as a counterbalance to equities. Historically, bonds have frequently risen when stocks have declined, and vice versa. They have also been much less volatile than stocks and generate reliable income as an asset class.

While investors were shocked by the rapidity of the interest rate rise (and price declines) in 2013, we remind you that bonds are nowhere near as volatile as stocks. The largest calendar year decline for bonds (10-year US Treasury notes) was approximately 11% in 2009. Compare this to the 38% decline in stocks in 2008, and you can easily see why bonds are considered much safer than stocks. In fact, bonds have registered full year declines in only three of the past 25 years. The significantly lower volatility of bonds relative to stocks is one of the key reasons Tandem uses fixed income as ballast in portfolios. All investments carry some degree of risk, which is linked to the return that investment is expected to provide. The general rule of thumb is the higher the risk, the higher the return. Thus, safer investments offer lower returns. During the Financial Crisis of 2007-2009, as some stocks declined by 50% or more, high quality bonds actually rose in price. This helped investors with bonds in their portfolios as it significantly reduced their portfolio losses. Balanced accounts may have declined 15% or so, rather than 50% or more for investors that were 100% in equities.

Unfortunately, bonds are not currently generating meaningful amounts of income. Rates have begun to normalize from the summer spike, with the 10-year US Treasury stabilizing around 2.75% after rising to 3.0% earlier this year. Meanwhile, the S&P 500 index yields 2.1% and most high-quality equities increase their dividends on an annual basis. We wrote about this in our May 2013 Manager Perspective: Total Return Investing vs. Income Investing.

The Federal Reserve has stated on many occasions that it does not plan to begin raising short-term rates until 2016, which should provide stability to the front end (shorter maturities) of the yield curve. Barring any unexpected spikes in inflationary pressures, we believe that rates will rise in a slow and gradual manner over the next several years. At Tandem, we have been focusing on very short-dated bond issues maturing in five years or less. Our concern about longer dated bonds is the short-term principal losses that could occur when interest rates rise.

We challenge market pundits who are discouraging investors from investing in bonds with our belief that modestly rising rates should in fact be welcomed by *long-term* investors, particularly in an era of generationally low yields. From current interest rate levels, interest income will be the primary driver of bond returns, and the ability to reinvest income into a gradually rising rate environment can increase total returns. So, for long-term investors, a modest rise in interest rates is actually preferred to flat or falling interest rates. In an atmosphere of slowly rising interest rates, investors can generate higher long-term returns, rather than lower.

In conclusion, bonds serve a valuable purpose for investors. Bonds provide relative stability and income, especially when equities become more volatile and unpredictable.

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