Just How Safe Are Bonds?

Ask most any investor if stocks or bonds are the safer asset class and the reply will come back almost automatically: "Bonds". Historically, that is correct. And over the last few decades, bond returns have not only been much smoother than equity returns, but have also outperformed equities for significant periods of time (for example, the entire 30 year period ending September 2011).

After such a long period where investors did not seem to be getting rewarded for taking on the extra risk of stocks, it's no surprise that retail investors were continuing to invest heavily in fixed income funds into 2013. This occured even as the stock market had more than doubled from its March 2009 lows.

However, the rapid rise in interest rates beginning in the spring and continuing into the summer has left returns on bonds negative for the year. The Barclay's U.S. Aggregate Government and Credit Index, a broad index of U.S. corporate and government bonds, was down 1.9 percent through September 30. Investors whose fixed income portfolios were concentrated in longer maturity bonds have lost 10 percent or more. The yield on the benchmark 10-year U.S. Treasury bond has increased more than one percentage point from its 2013 low of 1.6 percent in May to as high as 3.0 percent in early September. This is a modest move in nominal terms, but a very large move in percentage terms.

While not as severe as the stock market's decline in 2008, the decline in bonds came as a surprise to some investors accustomed to steady increases from that portion of their portfolio. With rates still low on a historical basis, the question on the minds of investors and financial market participants alike is: where do rates (and, by extension, fixed income returns) go from here?

Any discussion of interest rates must begin with an acknowledgement that actions of the Federal Reserve (Fed) have created a distorted interest rate market. In normal times, government bonds provide a "benchmark" interest rate, off of which other types of debt are priced. For example, a corporate borrower such as General Electric (GE) issues bonds at interest rates that reflect the rate of a risk-free U.S. Treasury plus a "spread" to reflect the default risk of the borrower. If the 10-year treasury is at 5 percent, GE's 10-year bonds might trade at 6 percent, with the extra one percent compensating investors for default risk. (While there are actually many other factors that can affect interest rate spreads, default risk is one of the most important).

After the financial crisis that began in 2008, the Federal Reserve instituted a series of extraordinary measures to help prop up the economy. In addition to reducing the Fed Funds rate to near zero, the Fed also began buying tens of billions of dollars a month in treasury and government agency bonds. The intended effect of these "quantitative easing" (QE) programs was to lower the cost of borrowing for individuals and corporations by reducing benchmark rates.

At least with respect to interest rates, the Fed's plan seems to have worked. When QE1 began in November 2008, 10-year U.S. Treasury yields were over 4 percent. Just a couple of months before QE3 began in the fall of 2012, the same 10-year rate hit an all-time low of 1.43 percent. Because bond prices rise as interest rates fall, bond investors were rewarded with price increases on the market values of their bonds in addition to recieving coupon payments.

Think about the coupon return as a "cushion" against rising rates. As the chart on page 3 shows, in years like 1980 and 1981, coupon rates were high enough to offset the negative price return from rising rates. This left investors with a net positive return. With the exception of 1994, 1999, and this year, coupon returns have helped investors achieve positive overall returns, as shown on the chart.

As interest rates decline, investors have a much smaller cushion and must rely more on price return. As interest rates fell from 2009 to 2012, price return made up a significant percentage of the total positive return for fixed income. The problem becomes obvious when you look at the year-to-date return for 2013 – coupon rates are so low that it takes very little in the way of interest rate increases to send the overall fixed income return negative.

This leads us back to the question that matters most – what does this artificially low interest rate environment mean for bond returns going forward? And how can investors help protect themselves against rising rates?

One important protection investors can build into their portfolio is keeping duration lower when expecting a rising interest rate environment. Duration is a measure of sensitivity to interest rate changes. In general, the shorter the amount of time to maturity, the shorter the duration of a bond.

The reason shorter duration portfolios are more protected from an increase in interest rates is that less time has to pass before bonds mature and the proceeds are available to invest at new, higher interest rates. The tradeoff for the increased safety of lower duration is less income in the short term, as longer maturity bonds generally pay higher interest rates.

Over the past few months at Trust Company of Oklahoma, we have been proactively reducing duration to better position bond portfolios for what we believe will continue to be a rising rate environment over the next several years.

Another way investors can reduce sensitivity to rising interest rates is to invest in segments of the fixed income market that may benefit from factors other than coupon payments and decreases in interest rates.

For example, high yield bonds (also called "junk" bonds) are debt issued by companies rated below investment grade by Standard and Poors, Fitch, or Moody's. These companies pay higher interest rates because the market judges them to have higher default risk, and investors must be compensated for taking on that additional risk.

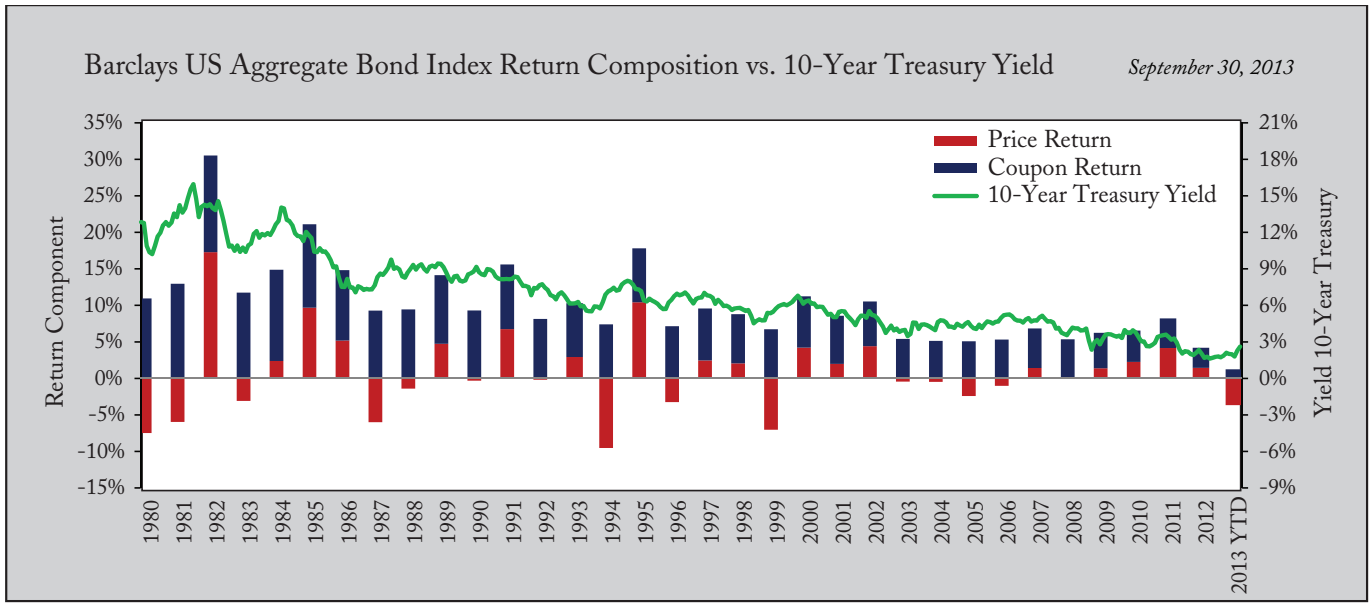
Companies that issue high yield bonds are generally quite sensitive to economic conditions. In a recession, default risk can increase significantly, resulting in negative returns. However, good economic conditions lowers default risk and can lead to high returns on high yield debt. Over the last five years, for example, high yield bonds have returned more than 11 percent per year as the economy recovered from the financial crisis.

Because high yield bonds have sources of returns other than interest rates alone, they provide diversification benefits to a fixed income portfolio. The same is true of other fixed income asset classes such as international bonds, Treasury Inflation Protected Securities (TIPS), investment grade corporate bonds, and municipal bonds where appropriate for taxable investors. While changes in interest rates are still going to be the most important factor in fixed income returns, combining all of these asset classes in a portfolio provides multiple sources of return, which lowers risk and can enhance return.

But even with a well-diversified, lower duration portfolio, investors must be prepared for returns over the next 10 years that are lower than fixed income returns have been over the last 10 years. Given where yields are now and the fact that interest rates are unlikely to go below zero, it's almost mathematically impossible for bonds to repeat their better than 5 percent per year performance. Exactly what the returns will be is impossible to know with certainty. Pimco's Bill Gross, known as the "Bond King," and manager of the world's largest fixed income fund, is on record saying investors should expect annualized fixed income returns at best in the 3 to 4 percent range. Others have predicted even lower returns.

Here at Trust Company of Oklahoma, we agree that interest rates will rise over the next few years. However, there is some good news. First, while the rise in interest rates will hurt the market value of bonds, investors will begin seeing an increase in income from their portfolios. And given the rise in rates this year, some of the pain of declining bond prices has already been felt.
Secondly, the Federal Reserve has made it clear that they will continue to try to keep rates low for an extended period, reducing the probability of rates jumping sharply higher from here. In fact, the Fed surprised the market in September by announcing that they would continue buying bonds at a pace of $85 billion per month. The news that there would be no "tapering" of purchases sent interest rates lower and bond prices higher.

In conclusion, fixed income investors have enjoyed a nearly uninterrupted 30-year bull market as 10-year treasury rates declined from double digits in the early 1980s to less than 2 percent earlier this year. That performance is unlikely to be repeated in our lifetimes. However, we believe careful control over duration and diversified sources of returns within fixed income portfolios will serve clients well in the interest rate environment to come.



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