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Bonds and Risk

Current Environment

Morningstar, Inc. has reported that over \$200 billion of new money has been added to bond mutual funds from January through August of 2009, while only roughly \$15 billion has been invested in stock mutual funds. That massive imbalance toward bonds is understandable to some degree, given the punishment inflicted on stock investors over the past year or so, but it also raises all kinds of contrarian red flags. Investors are notorious for buying high and selling low, and I wonder if this is yet another indicator that interest rates have bottomed out for this cycle.

A glance at the chart for the benchmark 10 year U.S. treasury shows an undulating downward slope from 9% in 1989 to today's yield of slightly more than 3%. In fact, at the depths of the credit crisis last fall, this yield almost touched 2%. With the nearly weekly accumulation of economic data indicating that the recession ended in the first quarter of 2009 and that stabilization in both the economy and financial markets has been achieved, it's reasonable to expect interest rates to return to more normal levels and cycle higher. Interest rates are artificially low due to the Federal Reserve's monetary policy and the numerous support facilities it has created to bail out segments of the U.S. financial sector.

The current parlor game of investment strategists is trying to figure out how the Fed extracts itself from the pervasive support it is currently providing without curtailing the nascent economic recovery and sending interest rates sharply higher. With the credit markets shifting back to normal, the Fed has begun to pull back from a number of the monetary facilities. The Fed's insurance of money market funds, a facility created when Lehman Brothers went under last year to stem the panic outflows from funds that were rumored to own Lehman commercial paper, has ended. Similarly, the Fed stepped into the commercial paper market last year as the buyer of last resort when that market seized up and corporations were unable to sell new paper, or rollover their maturing commercial paper, to finance their daily cash flow needs. The commercial paper market has recently returned to normalcy with more natural buyers returning and the Fed exiting.

The Fed has also announced that, by the end of the first quarter of 2010, it will likely stop the purchase of treasury and mortgage backed securities from the market, which has been a critical factor in keeping interest rates and mortgage rates near record lows. And finally, the Fed has announced that it will significantly shorten the term of loans for banks that borrow from it.

The consequence of the Fed exiting the various support mechanisms, along with the global economic recovery, muted as it is, may lead to the significantly higher rates from these record lows and that spells trouble for bond investors. Investors in long term bonds and bond mutual funds could see a sharp drop in prices as rates ratchet higher, thereby breaking the current bubble in treasury securities. At this point, it may be useful to review some bond fundamentals and the dominant risk characteristics associated with bonds.

Bond Fundamentals

The primary risks bond investors must consider are defined as follows: credit risk, interest rate risk, spread risk, and purchasing power or inflation risk.

Credit risk is simply the risk the issuer, which may be the U.S. government, a corporation like IBM or a municipality like the State of California, does not repay the stated interest or return the principal amount in a timely fashion. When you purchase a bond, the agreement is that you generally receive interest every six months and that your original amount invested is returned upon maturity. Any deviation from that contractual cash flow agreement may constitute default. The belief by investors worldwide is that U.S. treasury securities which are fully guaranteed in terms of timely repayment of interest and principal are “risk free” securities. Even amid the panic of last fall, investors globally sought refuge in U.S. government securities as a flight to quality occurred, driving prices higher and resulting in treasury securities providing some of the few positive returns for investors.

Because treasuries are risk free, they offer the lowest yields to investors and all other interest rates are generally set at some premium to the risk free rate depending on the degree of incremental risk. Corporate notes and bonds offer incrementally higher yields and are assigned quality ratings based on the financial strength of the issuer. In broad terms, bonds can be broken into two classifications: investment grade and non-investment grade, which are commonly known as junk bonds. Within each of these two classifications, bond quality is further segmented based on relative risk. Bond investors should never forget that higher yield equals higher risk, whether it is apparent or not.

Our bond portfolios were composed almost entirely of U.S. treasury securities leading up to the credit crisis last year and that helped us sidestep some of the painful turmoil other investors experienced. However, in late 2008 and early 2009, very short term (one to five years maturity with coupons of 4-6%), high quality corporate bonds were available in the market and we selectively purchased many for our clients, where appropriate. At present, it appears that window of opportunity has closed and that available corporate bonds no longer meet our risk parameters in most cases.

In sum, investors can easily control credit risk by deciding which bonds to hold along the quality spectrum of risk free treasuries to non investment grade junk bonds.

Interest rate risk is frequently misunderstood by bond investors and relates to the change in the price of the bond or bond mutual fund as interest rates cycle up and down. The mantra to remember is that interest rates and bond prices move inversely. For example, if you own a bond that currently pays 3% and interest rates rise to 5%, then the value of your bond can be expected to fall as investors will prefer the higher yield of 5% to your 3% bond.

Interest rate risk is a function of the general level of interest rates and the maturity of the individual bond. Bond pricing is all math, but we’re going to ignore the math and stick to the general concepts. In general, the lower the level of interest rates in the economy, the higher the interest rate risk, and the longer the maturity of the bond, the greater the interest rate risk. Therefore, with interest rates currently near record lows, interest rate risk is extremely high.

If you choose to or have to sell the bond before it matures, you may receive less than what you paid for it if rates have gone up. If you hold the bond until it matures, then you will receive your original investment assuming the issuer doesn’t default and you

paid par (or face amount of \$1,000) for the bond. However, holding a bond with a below market yield that has fallen in price due to a rise in rates precludes you from receiving a higher level of current interest income. Further, in order to avoid the potential loss on the sale of the bond, you may be forced to hold it to maturity.

A special problem develops with bond mutual funds as opposed to holding individual bonds. With an individual bond, your original investment or principal amount will be returned upon maturity. Bond mutual funds do not have maturity dates and therefore, there is no assurance that you will receive your original investment when you choose to sell the mutual fund. It is quite challenging to maintain the price of the bond mutual fund in a rising interest rate environment and consequently, bond mutual fund managers may soon be facing a considerable headwind in managing their portfolios when rates trend higher.

At this point, investors would be well advised to hold shorter term, individual bonds, not long term bonds, and should investigate the maturity structure of bonds presently held in their bond mutual funds.

Spread risk is really an “inside baseball” issue for professional bond managers, but it’s still worthwhile to be aware of it. As discussed earlier, all bonds are priced to some premium or spread off of the risk free rates available from U.S. treasuries. The higher the risk of the issuer, the greater the premium should be above the treasury security of a comparable maturity. However, the spread also fluctuates in response to the current economic cycle and the overall risk appetite of investors. In many respects, spreads can be used to gauge the level of anxiety of the bond market at any point in time.

For example, as the economy weakens, spreads typically expand with bond investors becoming more concerned with the issuer’s cash flow and capacity to repay the interest and principal. Wider spreads indicate that investors are less willing to take on risk. In contrast, with the economy expanding, investors tend to focus less on risk and are willing to accept smaller premiums. Consequently, spreads narrow. During the worst of the recent credit crisis, spreads expanded to record levels regardless of the underlying quality of the issuer. This convulsive price action created attractive opportunities for nimble investors in many high quality bonds.

Inflation risk or purchasing power risk is often overlooked by investors, but can insidiously devalue bond portfolios over time. Going back to the mechanics of how bonds work, you invest some principal amount in a bond, e.g. \$25,000, for a five year period at some stated rate of interest or coupon. You receive your semi-annual coupon payments and at maturity your principal investment of \$25,000 is returned to you. The problem is that inflation has most likely marched higher over that time period and at the long term annual rate of inflation of approximately 3%, the ability of your returned principal of \$25,000 to buy goods and services has declined by 15.9% or $(1.03)^5$. Until 1997, investors had no mechanism for dealing with this inflation risk.

Beginning in 1997, the U.S. government began issuing treasury inflation protected securities (TIPS). TIPS are treasury securities that are backed by the full faith of the U.S. government for timely repayment with the kicker that the inflation rate, as measured by the consumer price index, is added to the value of the bond each year (technically, each day). Utilizing our simple bond example, after year one and inflation of 3%, the value of your TIPS security - everything else being equal - is now \$25,750. Further, the coupon payment on the TIPS security is based on the higher principal

balance, which protects the income stream to you from inflation as well. The drawback is that the IRS deems that accreted inflation amount of your principal as taxable income even though there is no “cash flow” associated with it. To avoid this tax on phantom income, TIPS are most appropriate for tax deferred accounts, such as IRAs, 401ks, and tax free institutional investors.

The other downside to TIPS is that the coupon rate is less than that available on traditional treasury securities of a comparable maturity. The compensation for this below market coupon payment is the inflation accretion, which can be meaningful over time. In sum, TIPS can provide a credit risk free investment that offsets the erosion of purchasing power, and if one focuses on the shorter maturities, manages interest rate risk.

Summary

I have tried to cover the core risk concepts in bond investing, but this discussion is by no means definitive. There are many other issues for bond investors to contemplate such as duration, amortization of bond premiums, yield curve shifts, etc. that are beyond the time and space constraints of this newsletter. Nonetheless, the basics discussed here are sufficient to allow one to look through the simple decision of just buying the highest coupon available at any point in time. The dynamics of bond investing are often harder for investors to grasp than stock investing and a lot less exciting to talk about at cocktail parties. But given that most investors have some allocation to bonds in their investment portfolios, acknowledging and mitigating underlying risks is imperative.

Indeed, bonds are deemed to be less risky than many other investments and their negative correlation to stocks, unlike most other asset classes, make them particularly attractive during times of financial distress. That appeal may be a big reason investors have plowed, according to *Morningstar Inc.*, so much new money into them the past eight months. Or maybe they're just chasing a strong performing asset class during rocky markets.

With bonds close to secular lows in terms of yield, caution is warranted, and we prefer short maturity, high quality corporate paper to complement our existing treasury holdings. Long term treasuries seem considerably over valued with meaningful interest rate risk, and while we don't own them, shorting long treasuries could be profitable. Bond investors should always remember the positive relationship between risk and yield, and stretching for marginally incremental yield may bring regret when rates turn higher. Bond mutual fund investors should take a hard look at the underlying bonds held in their mutual funds and evaluate the mutual fund's interest rate risk exposure to a slowly rising rate environment.

Jeffrey M. Harris