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The Risks in the Bond Market

By Integer Wealth Advisors Group, LLC

This article discusses some of the current risks associated with investing in the bond market. We thought this piece was appropriate given the recent media discussion related to the potential “Bond Bubble.” An investor looking to buy bonds should be aware of the “three legged stool” that makes up a bond purchase: credit quality, duration and yield. Many investors are focusing on one leg, yield, while the risks of credit quality and duration are ignored. (For purposes of this discussion, bonds and bond mutual funds are synonymous.)

What Makes a Bubble?

Fear and greed drive bubbles. The bond market is being driven by fear of the unknown, the malaise of the general economy and the quest for higher yield. A potential bond market bubble, however, would not be on the same scope and froth as an equity bubble. The build is slower and the rate of return lower, but the general essence is present...fear and greed. There are, however, different risks that must be evaluated when considering where to invest in the bond market. These risks are manageable for the bond investor that monitors bond credit quality, yield and duration. The risk of a bond “bubble” today lies in the purchase of longer-term investment grade bond funds that have had the greatest run-up in price (see chart below). The risk is that investors are “buying high” to obtain slightly higher yields with higher credit qualities, versus managing their overall bond portfolio for a combination of yield, credit quality and duration.

Reinvestment Risk

Investors seeking higher yields must buy bonds that have the longest maturities and durations (duration is the measure of risk for a bond). With interest rates exceedingly low, corporations and municipalities are taking advantage of the rate environment by retiring outstanding bonds with high coupon rates and issuing new, longer dated bonds with lower coupon rates. Investors that have a bond “called” are experiencing

reinvestment risk...having to reinvest proceeds at lower yields. Instead of considering shorter-dated bonds, investors continue to move proceeds back into the next highest yielding security, pushing prices higher.

Opportunity Risk

An equity bubble generally leaves the investor with a significant reduction in value which can take years to recover. Investors who invested in the 2000-2002 tech-driven disaster understand this concept. The Nasdaq peaked in 2002 at nearly 5200 and has rarely, if ever, seen half that level. An investor today who buys a 30-year Treasury will not lose the principal value of the investment, and will receive their bi-annual interest payments promptly. The investor, however, will not maximize their investments because there are better opportunity risks to consider such as investing in shorter maturity bonds. The opportunity risk is that getting into the long-dated maturity is easy but getting out will not be fun when interest rates begin to rise.

Some suggest that with investments in fixed income mutual funds, the decline in principal is permanent. We believe that the active management of the underlying fund portfolio and the overlay of a strategic allocation that monitors duration and credit quality will provide better long term results than holding long-dated bonds with higher yields.

Inflation Risk

Inflation is a significant risk of owning bonds because the coupon of a bond is fixed and cannot be changed. As inflation rises investors sell their bonds to protect purchasing power which causes prices to decline and pushes yields higher. Also, there is an expectation that the Federal Reserve will react by raising interest rates to keep inflation in check, putting further pressure on the price of bonds. The severity of the price swing will be in relationship to the length and quality of the bond. Bonds with long durations are going to lose value in a greater proportion than those with shorter durations.

Bond Fund Review

We conducted a review of selected Morningstar data to identify the total returns from various types of bond funds for the first half of 2010. Using no-load mutual fund data we found the following results:

	Long Term Investment Grade (BBB or higher) (20 Funds)	High Yielding BB Rated or Lower (174 Funds)	Short Term Investment Grade (BBB or higher) (155 Funds)	Short Term BB Rated or Lower (10 Funds)
Avg. Return 6/30/2010	+8.32%	+3.90%	+2.76%	+1.73%
Avg. Yield	5.17%	8.0%	2.19%	2.86%
Avg. Duration	10.1 years	3.9 years	Less than 2 yrs.	Less than 2 yrs.

An investor facing reinvestment of bond proceeds or of idle cash, wishing to maximize yield would most likely consider the “BB” or lower rated category as an attractive investment with respect to yield. A further review of that strategy should be considered within the context of an overall fixed income allocation.

Long-Term Investment Grade Funds

The risk in this space is the duration. While the average yield is very attractive, and the credit quality is high, the investor buying in this space should understand the volatility is measured by duration. For each 1% increase in interest rates, the value of the bonds in the fund drops by the duration, in this case, 10.1%. Therefore, investors expecting rates to rise would not want to put all their “eggs” in this basket since we are currently at the lowest interest rate levels in over 40 years. If economic activity begins to pick-up and rates begin to rise, investors in this space will experience losses.

High Yielding BB or Below Funds

High yield bond funds should be compared to super safe investments such as the 10-year Treasury. The 8.0% yield provides a “spread” of 5.5% to a 10-year Treasury bond currently yielding 2.5%. Many funds in this space are below “B” which is pushing the average yield higher. Generally the time to purchase high yield is when the “risk premium” or “spread” is more like 700-1000 basis points in order to guard against excessive defaults of the issuers. Investors expecting a pick-up in the economy would be comfortable in this space since the default rates of issuers would

be expected to decline. However, the rule-of-thumb for the risk premium should guide the purchaser in this space.

Short Term Bond Funds

What stands out in this category is that the investor would do well to avoid the “less than BB” category and concentrate in the investment grade bond funds as the pick-up in yield does not justify the lower grade investment. Investors with cash that are looking for higher yields should consider the investment grade space with short-duration as an alternative to earning no interest on their money. However, the investor must understand the risks inherent in short term bond funds and realize that they could lose money. If you must have some cash in the portfolio, it is better to earn nothing and have the cash, than to put it at risk regardless of the pick-up in yield.

Overall Investment Approach for Bonds

As with every investment portfolio, diversification is the key to managing risk and this is no different for the bond market. Investors who have arrived late to the party and are loading up on higher yielding, high quality, long-dated bonds are setting the table for a disappointment. Investors who have owned these positions for the past few years should consider the duration of their fixed income portfolio, percentage of bonds invested in this space and make adjustments based upon their risk and reward position.

It is imperative that investors realize that with proper asset allocation and bond selection you can manage the risks inherent in the bond market. Inflation, opportunity, reinvestment and credit quality risks are always present in the bond market, regardless of current bond prices. Those investors who need more income should realize that now is not the buy bonds with long dated, higher quality maturities. That train left the station months ago and it would be better to wait on the sidelines and maintain an overall fixed income allocation that focuses on high credit quality and shorter durations.

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