Fixed Income Market Commentary

December 2012

DUMP YOUR BONDS? NOT!

Investors may have legitimate concerns about the bond market as 2012 comes to a close, but undisciplined or panic selling is not the right strategy to pursue.

In fact, any time someone suggests you sell all of anything, I hit the pause button.

The current state of the bond market—with ultra-low yields the norm—is prompting many fixed-income investors to consider selling their bonds. And who can blame them? The financial press has been highlighting bonds' dangerous sides while making subtle suggestions to sell. A recent article in the *Financial Times* quoted an "expert" referring to the current bond market environment as a "safety bubble," claiming it stands to inflict more pain than the dot-com bubble of the late '90s when it finally bursts. I couldn't disagree more.

For starters, I know the bonds I purchase for Adviser Investments' clients as well as myself may rise and fall in value after I buy them, but I take comfort in knowing that, on the day they mature, I will receive the bond's face value in full. I would wager that many dot-com investors would have been happy to simply have received back the commissions they paid on the stocks that went *pffft* during the tech bubble's collapse.

Successful investors balance their portfolios with allocations among stocks, bonds and cash—all other asset classes, if invested in at all, fall along the margins of a well-built portfolio. Eliminating bonds as an asset class—whether individual issues or funds—from this equation is a wrongheaded and dangerous move.

Having determined that an investor has a tolerance for risk that finds him comfortable with, say, an allocation of 40% of his portfolio to bonds, then why sell 40% of this portfolio just because interest rates are low? And exactly what is this investor supposed to do with the cash raised in liquidating his bonds? Should he add it to stocks, increasing his portfolio's risk though his risk tolerance has probably not changed one wit? How about adding to his cash reserves, which are currently paying single-digit yields? That doesn't make sense to me either. Rather, he should remain comfortable in the knowledge that his individual bonds, with locked-in yields that were acquired at a time when rates were more rewarding, are paying him considerably more than cash and maintaining a balance consistent with his risk tolerance.

The reason the press has been ringing the bell on bonds is due to the fear of the damage that can be done to bond prices when rates rise. The operative word here, however, is "when."

I'm fully on board with predictions of rising rates and have written many times that a rise is inevitable—just not imminent. But even if it were imminent, I still would not be dumping my bonds *en masse*. As bond investors, you and I have known for a long time that rates, after hitting historic lows, are poised to eventually trend higher. And with that in mind, I have been positioning our portfolios for just that outcome by staying far away from those longer-maturity bonds that have the most to lose when, not if, interest rates finally do begin rising.

But interest rates are not suddenly going to soar higher with the speed of a missile. I believe they will rise gradually, over a long period. So, rather than abandoning bonds, I am shortening up the average maturity of the securities in clients' portfolios and managing price sensitivity while concentrating on higher coupon bonds.

Barclays Fixed Income Index Total Returns Through 11/30/2012

	Duration	Nov.	YTD '12	Return '11	Return '10	Return '09
US T-Bill Index	0.32	0.02%	0.10%	0.15%	0.22%	0.37%
US Treasury Index	5.55	0.52	2.44	9.81	5.87	-3.57
US TIPS Index	5.04	0.48	7.68	13.56	6.31	11.41
US Aggregate Bond Index	5.00	0.16	4.36	7.84	6.54	5.93
US Govt / Credit Index	6.01	0.30	5.11	8.74	6.59	4.52
US Credit Index {A2}	7.10	0.00	9.46	8.35	8.47	16.04
US High Yield Index {B1}	4.15	0.80	14.02	4.98	15.12	58.21
Caa component	3.61	0.63	15.99	1.18	16.43	90.65
Emerging Market ($$) {BA1}	6.82	1.03	16.78	6.97	12.84	34.23
Municipal Index	6.06	1.65	8.12	10.70	2.38	12.91
Municipal Index - 5 Year	3.96	0.39	3.63	6.93	3.40	7.40
Municipal Index - Taxable	10.58	1.36	11.17	20.42	7.48	7.42

Source: Barclays Capital

Success in the asset management world involves having a discipline and sticking to it. Believe me, it takes a lot of discipline to settle for short-maturity bonds with yields of just 1% or less instead of reaching way out on the yield curve for 10 or 20 or even 100 extra basis points in annual payouts. Remaining properly defensive will mitigate much of the distress that the media's warning about.

Rather than listen to the press and dump bonds, my advice today is to lower portfolio duration and price risk, shorten average life and relax. I strongly advise against selling positions that have relatively high locked-in yields and decent coupon structures.

One last thing: Don't be afraid to invest in premium coupon bonds, or those with higher dollar prices. Investors who spend the income these bonds produce will, in effect, be spending down some of their principal, but I see nothing wrong with this as an interim strategy to tide you over until interest rates do eventually rise. After all – it's your principal that you will be paying back to yourself. As a wise investor once told me: "When you go to the store, they ask if you will be paying with cash, credit or debit card—not principal, interest or capital gains." Bonds will continue to help produce the cash you need to cover the bill.

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