
Is Your Bond Portfolio at Risk?

by Matthew S. Olver, CFP®, March 2011

The financial crisis and the Great Recession and their aftermath created conditions that could result in losses for which bond investors may not be prepared. We already have seen some of the effect as the 10-20 year Treasury Index declined more than 8% in the fourth quarter of 2010. While other topics are currently dominating the media headlines (Middle East, earnings, unemployment), we expect that at some point during the course of the year, the risks of bonds will likely be a hot topic of the talking heads on cable television shows and in the headlines of newspapers.

The purpose of this article is to answer some of the questions we expect to continue to get about the bond market, provide some perspective on the events that have taken place and insights into how we have prepared for the risks that you and other bond investors are facing in the future.

So what's the big deal?

The bond portion is typically thought of as the "safe" part of client portfolios, yet in the fourth quarter of 2010, the Barclays Aggregate Bond Index (broad index of government and corporate bonds) and Barclays Municipal Bond Index (broad index of tax-free municipal bonds) suffered losses of 1.3% and 4.2%, respectively, even after accounting for any interest income. As of mid-February, both indices were down another 1% year-to-date.

If it's the "safe part," how does it fluctuate?

Like buying a CD from your local bank, the borrower (the bond issuer) typically promises to pay the lender (the bondholder), regular interest payments until a certain date. At that point, the bond is said to have matured. When it reaches its maturity date, the full amount of the loan (the principal or face value) must be repaid to the bondholder. However, unlike a bank CD, if you have to sell a bond before its maturity date, you generally can't demand the issuer buy it back for an early withdrawal penalty; you will have to sell it in the secondary market at a price you and the buyer can agree.

Why would the price fluctuate?

There are many possible reasons, but the most important thing to understand is the inverse relationship between bond prices and interest rates. When interest rates are rising, bond prices tend to drop (and vice versa). That's because investors aren't as interested in buying a bond with, say, a 5 percent interest rate if they can buy a newer bond issue that offers 6 percent. If interest rates fall and new bonds are being issued with a 4 percent interest rate, an older bond that pays 5 percent becomes more valuable and its price rises. This is true not only for individual bonds but also the bond market as a whole.

What moves this “seesaw” relationship?

Interest rates generally move in the same direction as inflation expectations. Rising prices over time reduce the purchasing power of each interest payment a bond makes. Consequently, bond investors may start demanding higher interest rates to keep up with the rising costs of inflation (pushing existing bond prices down). In addition, the Federal Reserve may raise its targeted interest rates if it gets concerned about inflation. The theory is that rising interest rates will make it more expensive to borrow money, potentially decreasing spending, slowing economic growth and thereby easing inflation.

Bond prices also move up and down in response to investor demand for and issuer supply of bonds. For example, in a “flight to quality,” investors may be selling off more volatile assets, like stocks, to buy relatively more stable assets, like bonds. This higher demand would have the effect of pushing bond prices up (and interest rates down). Similarly, a tremendous amount of new issuance (higher supply) can have the effect of pushing bond prices down (and interest rates up) as issuers have to compete to entice the next buyer.

In other cases, a bond's price is affected by something that is unique to its issuer. Primarily, this pertains to the perceived likelihood that the issuer will make its interest payments on time and repay the full amount of the loan at maturity. All else being equal, the greater the chance of default, the higher the interest rate investors will demand (similar to individuals with lower credit scores having to pay a higher interest rate) and the lower the price to entice a potential buyer.

So what’s been behind the bond market’s recent moves?

A number of factors have converged to put upward pressure on interest rates and downward pressure on existing bond prices. By the end of the summer, exceptionally strong earnings improvements and positive economic data also made the relative attractiveness of equities to bonds too great to ignore. The tidal wave of new money that came into bonds since 2008 and contributed to historically low rates started to reverse, putting downward pressure on bond prices.

Inflation expectations picked up modestly as investors became more confident in the economic recovery and fears of a double dip recession subsided, aided by improved economic data, the Federal Reserve’s second round of quantitative easing and the federal government’s tax cut extensions. Higher inflation in food and energy, especially in emerging markets, also contributed to inflation fears domestically.

At the same time, these government actions further intensified concerns about the sustainability of the burgeoning US debt. If it leads to a devaluation of the US dollar, foreign investors may be less inclined to continue to buy our debt. This potential supply/demand imbalance could push rates higher/prices lower.

Consequently, since the end of September of 2010, the yield on a 10-year Treasury has gone from a low of 2.41% to a high of 3.75%. That is a significant rise in rates for an investment that arguably has no credit risk. Over the same time period, the Barclays Long-Term Treasury Index suffered a 10% loss.

Given the environment and the historically low interest rates (generally speaking), should I own bonds?

As I discussed in “Lessons we will likely learn this next decade” in May 2010, the important role that bonds play in the portfolio has not changed: to mitigate the volatility of a stock portfolio and provide for shorter-term cash needs. Although the fixed income markets certainly face some downside risks, they are not nearly of the magnitude of downside risks that stock markets can experience. For example, while the stock of AT&T may have a higher dividend yield than the yield offered by one of its bonds, the AT&T stockholder lost 27% of his investment in 2008 (even after factoring in the dividend). Many financial companies fared much worse.

Absent default, as long as bonds are held to maturity, bondholders will get the face value redeemed. Even in default, bondholders are higher in the capital structure and have a much greater chance of recovery than a stockholder in the event of liquidation. In fact, bondholders can frequently force a company to stop paying dividends before they stop paying interest on their bonds.

Moreover, it is too simplistic to generalize the entire bond market. Some sectors of the bond market still offer reasonable value while others may hold up better in value in a rising rate environment. Our goal is to prudently build a bond portfolio for each client to meet their goals and objectives (more on that below).

What is Spero-Smith doing to manage the interest rate risk?

We can address the risk of rising rates by matching up the time horizon of the bond investment with the timing of the cash need. Just as we own bonds so that we don't have to sell a stock at depressed prices, we do not want to have to sell out of a bond or bond fund at an inopportune time. This is one of the reasons we are always asking you to keep us informed of changes in the timing or amount of your cash needs.

We can also mitigate the risk of rising rates by staying more heavily invested in short-to-intermediate term bonds rather than longer term bonds. Longer term bonds generally suffer the greatest losses in a rising rate environment because the investor is locked in to the lower yield for a longer period of time. Therefore, a potential buyer will require an even lower price to compensate for the interest that could have been earned over the entire time period. With a shorter-term bond, if rates rise, you (or the potential buyer) will have the opportunity to reinvest into new, higher yielding bonds more quickly.

Our position in inflation protected securities may also be beneficial relative to other bonds if the rising rates are attributable to increasing inflation expectations. Government bonds called TIPS have a lower initial coupon, but provide an annual adjustment to your principal based on actual Consumer Price Index inflation. We may also utilize a tax-free municipal bond fund that hedges the inflation risk through futures contracts.

We continue to research and monitor other segments of the bond markets that historically have been less sensitive to rising interest rates. To the extent we take advantage of such opportunities, it will likely be through other professional managers, including our diversified bond mutual fund managers.

Why have municipal bonds faced even greater losses?

Municipal bonds were certainly affected by the general rise in interest rates but municipal yields rose more (and prices dropped more) because of a number of additional factors:

The passage of the tax bill, which kept income tax rates from rising for another two years, makes tax-exempt interest less attractive than it otherwise would have been, thereby reducing demand for tax-free municipals. At the same time, the bill did not extend the Build America Bond program, which allowed some tax-exempt borrowers to benefit from issuing taxable bonds. The end of this program effectively will generate a new supply of tax-exempt issues. This demand/supply imbalance helped to push rates higher (and prices lower).

The municipal market sell-off accelerated in December based on growing credit concerns. These fears were proliferated by the news media, perhaps best exemplified by the *60 Minutes* interview with banking analyst Meredith Whitney, in which she predicted a massive level of defaults. The common reasoning is that declining tax revenues caused by the economic recession and lower property values create fiscal challenges for states and local issuers of municipal bonds struggling to balance budgets; combined with the massive underfunded pension and health-care obligations, issuers will not be able to service their debt and default. Rumblings that Congress would consider a plan that would allow states to declare bankruptcy only exacerbated the concerns.

How serious are the default risks in the municipal market?

While we will likely see an increase in defaults in the municipal bond market, we do not believe it is probable that local government debt defaults will be widespread. Numerous organizations, including our fund managers, independent research providers, market strategists and the agencies involved in rating the debt themselves tend to agree with our perspective. Some of the more commonly cited reasons include:

- The sheer size and diversity of the municipal market means the risks of default are very specific to the circumstances of the particular issuer and the support for that bond. In the nearly \$3 trillion dollar municipal bond market, there are approximately 50,000 issuers with 1.3 million different bonds outstanding, backed by income taxes, sales taxes, property taxes, appropriations from legislatures or a dedicated revenue stream from something like a toll road or hospital.
- Budget deficits do not necessarily translate into bond defaults. In fact, debt service (e.g., interest payments) generally represents a small portion of overall budgets (4-6% of overall expenditures). So electing to default will not do enough to solve their fiscal problems. Further, there is a high priority for debt service, either because of a constitutional mandate (as in a state like California) or because doing so will likely cut off their ability to borrow in the future, crippling its long-term fiscal health.
- As mentioned above, municipal bonds are backed by a variety of sources and in many circumstances, the issuer is either required or at least has the ability to raise taxes and rates (e.g., water, power, sewer) to cover its debt obligations. For example, a school district bond voted on by taxpayers to fund construction of a new school is likely independent from appropriations from an annual levy. Voters may have initially agreed that school district has the right to raise property taxes to continue to pay the bond without further voter approval.
- The economy is improving and tax revenues are improving, decreasing the potential pressure on budgets. In fact, state and local governments collected \$22 billion more in the first three quarters of 2010 than they did a year earlier. Furthermore, in many areas, assessed values on properties generally didn't keep pace with the market values while prices were rising, so property tax revenues have not suffered serious declines.
- Although unfunded pension obligations are a long-term challenge, they will not threaten the ability of states to service their debts. As we have seen here in Ohio and Wisconsin, states are taking actions to fully fund their pension liabilities over the next 30 years, including lowering benefit levels for newer employees, raising the retirement age, and requiring higher employee contributions.

Historically, these reasons have contributed to the extremely low default rates of municipal debt. A recent Moody's default rate study indicated that less than 0.33% of issues ever rated by Moody's or S&P from 1970 to 2009 eventually defaulted. In contrast, the Moody's study indicated the default rate of rated corporate debt was over 11% for the same time period (1970-2009). Even in the Great Depression, the default rate for municipal debt only reached 1.7%. In 2009, 12 municipalities filed for Chapter 9 bankruptcy protection while more than 15,000 companies filed for the equivalent Chapter 11 protection. In 2008, according to Bloomberg, municipal defaults hit a record of \$8 billion while Forbes indicated \$158 billion of corporate bonds defaulted.

In general, we do believe the current fiscal challenges faced by states and local governments will lead to default rates climbing above their historical norms. And when a default does happen, it will generate media headlines and may heighten concerns, triggering temporary sell-offs. We will continue to monitor the situation closely, but at this time, we believe the fears of a massive wave of defaults are overblown.

What is Spero-Smith doing to manage the credit risk?

We can address the risk of not getting paid back through the quality of bonds we purchase and sticking to issuers that are in positions of financial strength. While we pay attention to the credit ratings of the popular rating agencies, we like to get the perspective of independent credit research organizations and input from various bond dealers. We also are able to leverage our stock valuation software to research and monitor the fundamentals of corporations in whose debt we invest.

Within the municipal market, we look for bonds that have sound backing, not necessarily from any bond insurance company, but from the underlying revenues that support repayment. General obligation bonds and essential service bonds have lower risk of default because of the ability to raise taxes and/or rates. Certain education and hospital bonds also have strong backing. Low income housing projects and tax-exempt debt issued on behalf of corporations have historically had the greatest chance of default. Even if a municipality has a lower credit rating, they may have issued bonds with a sinking fund provision (where the issuer gradually repays both principal and interest over time) or have been refunded in advance (money already set aside to pay off at maturity).

In many instances, we have found it more advantageous for clients to address the risk of default by diversifying through bond funds instead of individual bonds. Even with significant due diligence, there is the chance we are wrong or that events outside the control of the issuer threaten the ability to pay (e.g., hurricanes in New Orleans). If one bond defaults inside a mutual fund with hundreds of holdings, the impact will be much more negligible than if it is one of five holdings. Further, the dollars and manpower fund organizations can commit to research should not only help them avoid defaults, but also scour the universe for opportunities to pick up yields/lower quality issuers that we might be unwilling to do within the safe portion of client portfolios.

But aren't bond funds even worse to own in this environment?

We have heard this argument in both the popular press and by some other advisors. The theory behind this is that "unlike a mutual fund bond investor who suffers an immediate loss when interest rates increase and the value of their holdings drop, the individual bond investor can hold their bonds until their due date and sustain no loss." Because there is no maturity date on a bond fund, there is no certainty that bond funds will return to the full purchase price.

We are certainly aware of this risk and have communicated it to clients for years. However, similar to mutual funds, individual bonds will suffer similar immediate price losses during a rising rate environment. That unrealized loss is only erased if you do not have to sell at depressed prices and can hold to maturity. Along the same lines, if you hold a bond fund over the appropriate time period and do not have to sell it prematurely at depressed prices, the loss can be mitigated.

That "appropriate time period" can be measured by the average duration of the bond fund. Duration is a calculation of the weighted average time of repayment. It also provides a measurement of sensitivity of the fund to changes in interest rates; the longer the duration, the higher the sensitivity to interest rates. So we can manage the interest rate risk by understanding the portfolio characteristics of our bond funds, including its duration and matching the appropriate fund with the client's cash flow needs (as discussed above).

Further, the individual bond argument assumes the bond holder receives his/her full principal value at maturity. The immediate diversification that bond funds provide can mitigate the loss that might be sustained by a single default within the portfolio. Staying with the absolute highest quality/lowest risk individual bonds provides more certainty, but also gives up a significant amount of yield potential. A good bond fund manager can capitalize on the fears and uncertainties of this market to provide additional yield, which would help

cushion any price declines sustained during a rising rate environment. Finally, a bond fund manager can more cost effectively reposition a portfolio to invest in the new higher rate offerings as they happen; whereas the transaction costs to an individual investor trying to trade small pieces of individual bonds can be much more than the operating expenses of a mutual fund.

It is possible that in a prolonged period of rising interest rates, a bond fund's price will not recover to a previous high water mark. However, we believe the additional yield these professional managers can generate by capitalizing on opportunities across the entire bond market, including being able to "trade up" for new, higher yielding bonds, helps offset, to some extent, any drop in principal value; while simultaneously being able to diversify the credit risk inherent in any one holding.

Summary

For the better part of three decades, bond prices have been on the rise as inflation has fallen from mid-double digits to very low-single digits. Interest rates followed suit and bond investors had the benefit of experiencing significant price appreciation in addition to the interest earned. As I discussed in "Lessons we will likely learn this next decade" last May, investors need to recalibrate their expectations for bond returns as it is more likely we will see rates start to rise and the possibility you could experience a loss if you must sell when bond prices are down.

The important role that bonds play in the portfolio has not changed: to mitigate the volatility of a stock portfolio and provide for shorter-term cash needs. The more informed we are about your cash flow needs and the timing of them and the more we understand about your need and desire for the balance between return and risk, the better able we will be to appropriately structure your portfolio to achieve your financial goals.

While we may not be able to eliminate the risks or avoid the fluctuations within the bond market, we have prepared for them and have taken steps to control them by matching up the time horizon with the cash flow need, positioning the portfolio in less interest rate sensitive areas, and addressing the risk of default with due diligence and diversification. We saw some evidence of our successful preparation in the fourth quarter of last year, when our diversified fixed income portfolios generally experienced less than half the loss the broader bond market indexes suffered.

Thank you for the opportunity to serve as your investment advisor and to help you accomplish your financial goals in the years ahead.

About the Author

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Matt joined Spero-Smith Investment Advisers, Inc. in June 1997 and was promoted to Senior Vice President in July of 2009. He is responsible for the oversight of the personalized investment strategies and financial planning consulting services for new and existing clients of our firm, including individuals, retirement plans, institutions and endowments.

Matt is a Certified Financial Planner™ practitioner and a member of the National Association for Personal Financial Advisors (NAPFA) and the Financial Planning Association (FPA).

Graduating magna cum laude from John Carroll University where he received a Bachelor of Arts in Economics in 1997, Matt is still active in the John Carroll community as a member of the JCU Entrepreneurs Association and JCU Magis Advisory Group. He is a graduate of the Cleveland Bridge Builders Class of 2006.

He is a regular contributor to the “Ask the Expert” column in Cleveland’s *The Plain Dealer* and has been quoted in various newspapers and periodicals on investment strategies, mutual funds and 529 college savings plans.

About Spero-Smith Investment Advisers, Inc.



INVESTMENT ADVISERS

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As a fiduciary to our clients, we have a commitment to act with undivided loyalty to them. The only compensation we receive is paid directly by our clients. By design, our decisions and recommendations are completely objective and based on each client’s particular financial situation and objectives.

Spero-Smith relies on the talent, knowledge and expertise of the entire professional team to best meet the needs our clients. Our Chief Executive Officer, Robert C. Smith, and Chief Investment Officer, Mimi E. Lord, CFA, CFP® collectively have over 45 years of experience in financial and investment consulting for individuals and businesses. They are supported by a team of professionals with advanced degrees and other industry certifications, with areas of expertise in investments, retirement, estate, tax, and education planning.

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