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ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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A Bond Market Crash Course

You may have seen stories over the past few months touting the fact that, over the last 10- or 40-year periods, bonds have outperformed stocks (albeit by a slim margin). It would be a mistake, however, to make a wholesale change to your investment strategy predicated on the belief that bonds will continue to outperform stocks over the next decade, or that the prospect for asset growth is better in bonds than in the stock market. While periods of bond outperformance can be cherry-picked out of the long history of the U.S. stock market, over the vast majority of time periods, stocks have outperformed bonds by a healthy margin.

That said, at Adviser Investments we have always felt that bond funds have a place in even more aggressive portfolios for their ability to provide diversification, temper risk, generate monthly income or, at the very least, act as a higher-yielding cash substitute. With the recent media attention spotlighting bonds and the flight to the safety of US Treasury issues, we felt this would be a good time to highlight some of the things an informed investor should know about bond investing and then take a look at our current favorites among Fidelity and Vanguard's offerings.

Bond Basics

A bond is a debt instrument issued by a company, institution, city, state or federal government for the purpose of raising capital through borrowing. When you buy a bond, in most cases, you are buying a promise that at its maturity date, you will be repaid your capital and will earn regular interest payments along the way (there are bonds that do not pay interest, called zero coupon bonds, however). A bond fund is an investment in many bonds of similar characteristics packaged together. When choosing a bond fund, the three main considerations are its risk (or quality), the time to maturity and its yield (a bond's yield is calculated by dividing the bond's price by the income it generates; for that reason a bond's price and yield have an inverse relationship—when the price goes up, the yield goes down and vice-versa).

One of the biggest risks in bond investing comes from the likelihood that your initial investment may not be paid back upon maturity, also known as defaulting. US Treasury bonds are, for that reason, considered the safest investments and have the highest quality ratings, as the probability that the government will default on its debt is nearly zero. In general, the riskier a bond (or lower the quality), the higher its yield will be to compensate for that risk of default. Bonds with a longer maturity can also be riskier, as over time the price can fluctuate more and be negatively affected by inflation. A general rule of thumb is that longer-maturity bonds are at higher capital risk while shorter-maturity bonds have more income risk.

When picking a bond fund, you should also consider its interest rate risk; the effect of rising interest rates on the price. Generally, when interest rates rise, bond prices will go down. The best way to measure a bond fund's interest rate risk is to take a look at its duration, which is a measurement in time. For example, if you have a fund with a duration of 5.2 years and interest rates move up by 1%, you can estimate that the fund will lose 5.2% of its value. For this reason, bond funds with longer durations quickly become undesirable heading into a rising interest rate environment. Treasury bonds are also the most sensitive to periods of rising and falling rates, due to a lack of credit risk (the risk of default).

There are some bond funds where the duration measure won't tell you as much, such as GNMAs (both Fidelity and Vanguard have funds focused on these mortgage bonds), and junk bond funds. GNMA funds hold a large number of securities whose duration fluctuates unpredictably, and junk bond funds' risk is closer to that of the stock market.

Another thing to consider when choosing bonds is whether a taxable or tax-free fund is more appropriate for your portfolio (this only applies to taxable portfolios). One means of making this determination is to calculate your "tax-equivalent yield." To do this, take your federal tax rate, subtract it from 1 and then divide the current yield on a tax-free fund by that number—if the result is higher than the yield of a comparable maturity (or duration) taxable fund, you'd be better off with the tax-free. For example, let's say you want to compare two short-term funds, one taxable, one tax-free. The taxable fund has a yield of 2.36% and the tax-free is yielding 2.09%. If you are in the 28% tax bracket, you would subtract 0.28 from 1 to get 0.72, then divide the yield of 2.09% by that 0.72; in this case, the calculation results in a tax-equivalent yield of 2.90%. So here, the tax-exempt fund might make more sense for your taxable portfolio, since its tax-equivalent yield is significantly higher.

Fidelity and Vanguard's Best

Fidelity and Vanguard both cover the bond universe pretty thoroughly, each with many choices from high to low quality and short to long maturities. Most of the firms' funds benefit from top quality management, but we only find a few of the funds from each family worthy of our clients' portfolios right now.

We've based our current bond fund choices on a number of factors, but the main considerations have been the flight to safety (the high demand for Treasury-issued bonds, which has pushed prices on Treasury bonds up while spurring a corresponding drop in yields) and the looming—but not rapidly approaching—inevitability of interest rate hikes and inflationary concerns. As such, we favor Vanguard's Short-Term Investment-Grade and Intermediate-Term Investment-Grade funds, along with Fidelity's Intermediate Bond and Total Bond funds. All of these funds invest in high-quality "investment-grade" or corporate bonds (although they are of lesser quality than Treasurys, thus carrying more risk), and the yield is substantially higher than on comparable Treasury funds. For example, the yield at April's end on Vanguard's Intermediate-Term Investment-Grade was 5.98%; 360 basis points (3.60%) higher than that of Intermediate-Term Treasury's 2.38%. That's a substantial income advantage for only moderately increased credit risk, and you'll see similarly wide spreads when comparing the yield on the other funds listed above with a comparable Treasury or government fund.

We've also begun to consider positions in Fidelity and Vanguard's TIPs (Treasury Inflation-Protected Securities) funds, which invest primarily in inflation-indexed bonds. They rise and fall on moves in interest rates along with other funds, and both Vanguard and Fidelity's funds will most likely move in line with an intermediate-term Treasury fund. With interest rates at historic lows and inflation likely to return at some point (it is not a huge concern as of yet, however), an investment in either Fidelity's Inflation-Protected Bond fund or Vanguard's Inflation-Protected Securities might be worth considering, although we would only recommend either of these funds for longer-term investors (investors seeking monthly income should also be aware that Vanguard's fund makes distributions quarterly, not monthly).

Adding Bonds to Your Portfolio

If and when you decide to add a bond component to your portfolio (or you are reassessing bond funds you currently own), take some time and review those attributes we've discussed above, along with how the fund's objective fits in with your investment goals. Are you looking for a shorter-maturity fund that will work as an income-generating cash substitute? Do you need high levels of current income? Are you looking for a hedge on inflation? These answers to these kinds of questions can go a long way towards steering you towards the right fit for your portfolio. While bonds are not going to be your path to high octane performance over most time periods, they can give you great mileage and can provide low-risk, steady earnings along the way.

About Adviser Investments

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,500 clients and $850 million dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 35 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

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