Fixed Income Market Commentary

July 2013

The Bond Market's Demise is Overstated

An old truism in the newspaper business is that "if it bleeds, it leads" and so I find myself once again coming to the defense of the bond market, which has been maligned in the financial press this past month as prices, after a 32-year bull market, have taken a bit of a turn.

Not surprisingly, the press's tone and language is nothing short of sensational, and many investors (and clients) I've heard from sound ready to make a kneejerk move and abandon ship. I think that would be a mistake.

Many investors and market-watchers seem predisposed to the view that ***all*** bond investors are about to be soaked by rapidly rising interest rates (and the related decline in prices). They are wrong. I cannot emphasize enough that bonds are not an asset class to be abandoned, but to be managed. Any advice to bring your portfolio's fixed income weight to zero is downright irresponsible. In any well-balanced and diversified investment portfolio there is always going to be some portion that is underperforming the rest. One stock or mutual fund will be lagging the others, or bonds as a whole may be trailing stocks. Domestic stocks may lag foreign stocks, or vice versa. Reacting to these scenarios by completely eliminating the underperforming component amounts to market timing, and is not smart, balanced, long-term investing.

Yes, bonds did post losses over the past two months or so, but judging by the hype and sensationalism you'd think the selloff was a complete disaster. Perhaps I'll be the first one to tell you this—it wasn't.

Rising interest rates hurt the prices of long-maturity bonds the most, and short-maturity bonds the least. The long end of the bond market took its lumps, with 25-plus-year maturity Treasury bonds losing 12.1% from the end of April through early July. But who owns just 25- and 30-year Treasury bonds? We certainly don't.

For a better understanding of how the bond market is doing compared to the portfolios I am managing, I think it's worth considering the three- to five-year sleeve of the Barclays U.S. Aggregate Bond Index—an index that includes both Treasury and investment-grade corporate bonds in its mix. That index lost 1.7% over the exact same period that long Treasurys took double-digit drops. A decline of 1.7% is a long way from a disaster for an asset class that has served many of our clients well and allowed them to sleep when other areas of the market, such as stocks, were in retreat.

Rising interest rates are part of a normal market cycle, even if we have not seen them in quite a while. The 30-plus-year bond bull market lasted longer, and saw interest rates drop further than almost anyone could have imagined—including me. This first leg of the return-to-normal cycle took bond yields higher than I anticipated—the 10-year Treasury's yield hit 2.75% recently—but this is no cause for panic. Even if I had called the recent rise in interest rates precisely, I wouldn't have changed my tactics. If anything, I see opportunity in higher interest rates. In fact, we may be testing the bounds of a new trading range for bonds, which were trading between about 1.6% and 2.0% and now may hover between 2.5% and 2.8% or so.

Barclays Fixed Income Index Total Returns Through 6/30/13

	Duration	June	YTD '13	Return '12	Return '11	Return '10
US T-Bill Index	0.32	0.01%	0.06%	0.12%	0.15%	0.22%
US Treasury Index	5.15	-1.10	-2.11	1.99	9.81	5.87
US TIPS Index	7.17	-3.58	-7.39	6.98	13.56	6.31
US Aggregate Bond Index	5.49	-1.55	-2.44	4.22	7.84	6.54
US Govt / Credit Index	5.68	-1.80	-2.67	4.82	8.74	6.59
US Credit Index {A2}	6.75	-2.85	-3.60	9.39	8.35	8.47
US High Yield Index {B1}	4.41	-2.62	1.42	15.81	4.98	15.12
Caa component	3.83	-2.38	5.29	18.34	1.18	16.43
Emerging Market ($$) {BAA3}	5.86	-4.47	-6.52	17.95	6.97	12.84
Municipal Index	7.94	-2.83	-2.69	6.78	10.70	2.38
Municipal Index - 5 Year	3.88	-1.59	-0.89	2.96	6.93	3.40
Municipal Index - Taxable	10.59	-5.08	-4.56	10.86	20.42	7.48

Source: Barclays Capital

Managing a portfolio of individual bonds is all about risk control. For years at Adviser Investments, we have been expecting the artificially low interest-rate environment to correct. In anticipation of such a correction I have kept a fairly tight lid on exposure to long maturity bonds, or those maturing in 15 years or more. My goal has been to maintain a weighted average maturity of around five years in client portfolios, mixing some intermediate-maturity bonds with some that were shorter. In fact, a large number of the accounts I manage today carry a weighted average maturity that is closer to four years, as I positioned them for what we've finally seen over the past couple of months.

So why are rates going up? It certainly isn't because the Federal Reserve has cut back on its bond buying or raised interest rates. Rates are going up primarily because some investors are trying to get ahead of what they *think* the market may do some time in the future. The "taper" talk or moderation in the size of the Fed's asset purchases is what spooked some investors. So be it. This return to normal is not the end of the line for the bond market, it's just the next phase—one with the higher yields that many have been clamoring for and that we can advantage of.

Investors should be happy that interest rates are rising. In part, it acknowledges the recovery our economy has made since the financial crisis in 2008 and 2009. As for how investors should deal with this next stage in the bond market, my advice is to stick with the plan we have worked on together while remaining aware of where our risks lie, and where they don’t. This strategy has served us well over the years. And if the major bond market indices show additional weakness on the long end, remember that your portfolio is already positioned where the effects of such an outcome are mitigated.

Christopher Keith
Senior Vice President
Fixed Income Manager