Fixed Income Market Commentary

September 2012

Buy and Hold Bonds, Too

Investing can be simple or it can be complex. And complex doesn't always mean "better."

A rather simple strategy that has worked wonders for years—buy and hold—has recently come under fire from pundits who believe that the investment principles of the past are outdated in this "new normal" economy and market. They are wrong.

Adviser Investments' Chairman Dan Wiener has recently written a report that debunks the myth that "buy and hold" stock market investing is dead. (You can find a copy by clicking here.)

But what Dan left for me to focus on was the fact that "buy and hold" works pretty well for bonds, too.

I raise this subject now because I see more and more doomsday predictors claiming that the bond market is about to be swamped by a wave of rising interest rates, leading to losses for those who hold fixed-income securities. Again, I think the pundits are wrong.

First, predictions of rising interest rates have been a regular feature in the investment markets for years. Yes, this line of thinking does have some degree of merit but the doomsayers haven't gotten it right yet. I'm not being smug about this. As I wrote to you in April ("First Quarter Review"), I believe rising interest rates are inevitable, but not imminent.

I don't have to go very far out on a limb to say that rates will rise *eventually*. But when rates do begin to rise, I believe it will be at a gradual pace, something the gloom-and-doom crowd isn't saying. If I'm right, those making the dire predictions will look pretty silly in hindsight.

Already growing slowly (GDP is the highest it has ever been, though you wouldn't know it from the news teams focused on every downtick in investor sentiment), the economy will eventually pick up speed as the various stimulus packages and quantitative easing programs that Congress and the Fed have in place bear fruit. The trick, of course, is to figure out when all of this will happen, and then, how quickly interest rates will begin rising. I wish I could offer more insight there, but my crystal ball is covered with Greece, among other troublesome issues.

"Don't fight the Fed" is a common bond-market catchphrase taken to mean that, so long as the Federal Reserve is lowering interest rates or keeping them low, you shouldn't bet against the market. The Fed has publically stated that they have no reason to believe they'll be raising rates any time before late 2014. This gives us a pretty good picture of what to expect from monetary policymakers. Investors, on the other hand, will likely act in advance of the Fed and begin selling bonds (raising interest rates) if they see economic improvement. But even so, the change should be very, very gradual.

Therefore, I'm not sure how selling your bonds today—bonds that have locked-in yields that were acceptable when purchased—helps you. Where will you put the cash from your bond sales, exactly? Money market funds currently yielding less than 0.05%? Certificates of deposit aren't much better, either.

Are the bond bears suggesting that you sell your bonds and then invest in a different and possibly riskier asset class? That doesn't make any sense to someone who believes that strategically diversified portfolios are an investor's best offense and defense.

Barclays Fixed Income Index Total Returns Through 8/31/12

	Duration	Aug.	YTD '12	Return '11	Return '10	Return '09
US T-Bill Index	0.33	0.01%	0.07%	0.15%	0.22%	0.37%
US Treasury Index	5.69	-0.13	2.40	9.81	5.87	-3.57
US TIPS Index	6.23	-0.29	5.71	13.56	6.31	11.41
US Aggregate Bond Index	5.02	0.07	3.85	7.84	6.54	5.93
US Govt / Credit Index	6.05	0.02	4.35	8.74	6.59	4.52
US Credit Index {A2}	7.06	0.21	7.60	8.35	8.47	16.04
US High Yield Index {B1}	4.01	1.17	10.59	4.98	15.12	58.21
Caa component	3.48	1.32	12.21	1.18	16.43	90.65
Emerging Market ($$) {BA1}	6.75	1.22	12.40	6.97	12.84	34.23
Municipal Index	6.98	0.11	5.43	10.70	2.38	12.91
Municipal Index - 5 Year	3.99	0.05	2.63	6.93	3.40	7.40

Source: Barclays Capital

Rather than indiscriminately selling your bonds, it makes more sense to be strategic when adding to your portfolio. *Critically, it pays to focus close attention on the maturity structure of your holdings*.

I'm actively working to brace clients' portfolios against the potentially harsh effects of interest rate spikes by keeping one eye on today's market and rates and the other on what I expect to see down the road a year or more out. To wit, I'm searching for—and finding—bonds that are particularly attractive today while considering how I'll invest and reinvest principal in another year or two when rates do eventually rise. My goal is to have some dry powder (cash) to reinvest when the inevitable is actually imminent.

Partly, I'm reducing risk by adding to the shorter-maturity positions in client portfolios. It takes a fair amount of discipline to do so, but settling for yields approaching 1% instead of reaching for 3% or 4% on bonds with 20- to 30-year maturities will prove to be the right move when rates eventually rise. I am currently targeting an overall weighted average maturity of less than five years in most portfolios. That said, I still do maintain a modest weighting in longer bonds—bonds with a 10- to 15-year maturity—to protect the portfolios if rates don't rise.

A "buy and hold" strategy works perfectly well for bond investors if you pay close attention to the specifics mentioned above. It has always been my contention that structure matters, and it matters even more now than it has in a long, long time. In this low-interest-rate environment, portfolios with an overweight on the short end of the maturity scale will hold up better than a portfolio overladen with long maturity bonds.

So, don't sell your bonds; hold onto them. After all, they still serve as a lower risk, lower volatility asset that provides income and returns your principal/face value at maturity. Just because issuers from the U.S. Treasury to municipalities to corporations are issuing 30-year bonds doesn't mean you should be buying them.

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