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Bond Portfolios: Their Purposes and Prices

It seems that barely a day has gone by in recent months when the financial press has not addressed how rising interest rates are forcing bond prices down. Many articles give the impression that the bond market is on the cusp of a rout. Given the changing landscape for the bond market, what, if anything, should be done? This question relates directly to our firm's philosophy that an investor's investment policy (the proportion of stocks and bonds in a portfolio) should not change radically due to market conditions. A related question is how this philosophy gets applied when we weigh the effect of market forces on your portfolio.

First, it's important to keep in mind that the fundamental reason for having bonds in a portfolio is to provide a complement to the behavior of stocks. Many of the events that could trigger a drop in the stock market are neutral or positive for bonds, making bonds an "anchor to windward" in a stock market sell-off. Eliminating all the bonds in your portfolio would remove an important balancing feature that may be needed should something unpredictable happen that hurts stock prices.

Let's review the basics of bond pricing and how bonds and stocks typically behave; these are important considerations in developing and managing a portfolio. The key axiom of bond behavior is that as interest rates decline, bond prices rise. A simple illustration is that a $100,000 Treasury Note issued in 2000 with a 5.75% coupon rate can be sold today for $110,000 because the prevailing yield for ten-year Treasuries is now 4.44%. As you can see, when prevailing interest rates decline, the bond's price increases. The opposite is also true: when interest rates rise, bond prices decline.1

This is where a particular total-return feature of bonds arises. The total return of any investment is its income plus its change in price. However, one important difference between stocks and bonds is that the income component of a bond's total return (interest) is typically higher than that for a stock's (dividend). For example, intermediate term bonds are yielding approximately 4.5% while the yield on stocks (dividend to price) is more in the neighborhood of 1.6%. Why is this important? The price of a bond, unlike a stock, can drop 4.5% before the

[1] Assuming all other factors, such as credit quality, remain the same.

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total return reaches zero. This is but one reason why bonds can be less volatile than stocks. It is also an important factor when we look at the long-term strategy in dealing with bond portfolios.

Looking forward, and applying the concepts described above to your portfolio management, we need to consider how quickly bond prices could change. We know that interest rates are at a 45-year low. If interest rates rise suddenly and dramatically, there is no doubt that bond prices would take a sudden and dramatic hit. But in this interest rate environment, where a mere four or six months ago the concern was about deflation and falling interest rates, there is no dramatic indication of inflation on the horizon (interest rates typically correlate well with inflation rates). Interest rates are rising now primarily because people expect the economy to pick up and they expect interest rates for lending to rise as a result. Again, the question is how quickly the economy will pick up. There is no consensus that it will happen suddenly. So there may be a gradual impairment of bond prices, but perhaps not a dramatic one that wipes out the total returns of bonds. Or, in other words, there may be a long-term erosion of the total return of short-term and intermediate-term bond positions, but we don't think the bond portfolios our clients typically hold will suffer a dramatic price hit that wipes out much more than the interest bonds are paying.

Consequently, as the year goes on and we assist in rebalancing portfolios, we expect to recommend some tactical adjustments in the types of bonds our clients hold. None of these changes warrant an "all points bulletin" where we contact all our clients and say we want to make dramatic changes today. There may be evolutionary changes that we recommend in asset class percentages and perhaps gradual changes in managers, although we have none in mind at the present. We have considerable confidence in the bond managers who have worked with our clients for years and have long track records and considerable experience. Having expert managers who continually modify bond portfolios is another benefit of the approach we use. We have been in contact with your bond managers and know that they are adjusting the types of bonds they're holding, including modifying portfolio durations, maturities, and credit qualities in an attempt to deal best with the evolution to higher interest rates which seems inevitable.

If you would like to discuss any aspect of bond management or any other topic, please give us a call. As always, we welcome your questions and comments.

Sincerely yours,

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