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Are Your Bonds on Steroids?

Publication title: **Not sure what bonds you hold? Then find out**

The ongoing turmoil in the world's credit markets presents a perfect opportunity to re-examine the role that bonds should be playing in your portfolio.

The current crisis developed over the last half decade in sub-prime residential mortgages extended to the least credit-worthy borrowers. These loans were packaged in billion-dollar securities pools called Collateralized Debt Obligations (CDOs) and sold to institutional investors such as pension plans, hedge funds, and mutual funds—and may even be lurking in your portfolio.

With little or no money down and adjustable interest rates, speculators also used these mortgages, hoping to capitalize on the frothy real estate market in some states.

Collateral Damage

The recent meltdown occurred when the owners of these securities got spooked by a combination of interest-rate adjustments and falling real estate prices. This uncertainty resulted in the inability of the markets to value these complex products. To make matters worse, giant hedge funds had leveraged their portfolios with margin money borrowed from banks and brokerage firms.

When these margins were called, fund managers—unable to sell the CDOs—sold liquid securities in their portfolios, such as stocks. We observed one downside of our increasingly in-

Summary: Are your bonds on Steroids?

Bonds can be a good hedge against stock volatility, but you need to invest in the right bonds.

Bonds are not for juicing your returns. Homeruns come from stocks. Bonds are for playing defense and for moving the runners along slowly—with bunts and singles.



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Your Way to Prosperity

tertwined global financial markets: stocks tumbled worldwide by 10% in a few weeks.

First Principles

For the 80 years for which we have records, equities have outperformed bonds by a wide margin, illustrated by average annual returns since 1926:

- One-month U.S. treasury bills: 5.9%
- Long-term government bonds: 5.4%
- Long-term corporate bonds: 5.9%
- Stocks: 10.4%

So, why not just own stocks? The short answer is—as we know—stocks are risky.

The Why and How

Fundamentally, bonds are used to reduce overall portfolio risk, smoothing out the ride during inevitable stock market swoons. But, it matters how you use bonds or, more importantly, which bonds you choose. And, bonds can be risky, too: they face credit and interest rate risks. However, high-quality, short-term bonds—for practical purposes—can't lose their value, which means they do the job of preserving portfolio capital.

Quality and Maturity

Credit risk is the possibility that a bond's issuer—a government entity or corporation—will default on its obligations. U.S. Treasury obligations are considered to have no default risk. Government agencies, such as FNMA, carry an implied government backing. Next come AAA-rated corporate and municipal bonds. Bond risk increases as we proceed down the food chain toward high-yield or “junk” bonds.

The well-known inverse relationship between interest rates and bond prices reveals interest rate risk. When rates go up, bond prices go down—and vice versa.

Longer maturities intensify this relationship. Historical data demonstrate that maturities beyond seven years simply don't pay: returns have been lower and risk—as measured by the standard deviation which describes variability in returns—has been substantially higher.

When rates rise, recent additions of long-term bonds to a portfolio create a dilemma: stick with the long-term purchase or sell at a loss to reinvest at higher rates. By contrast, an investor in short-term bonds is already positioned to reinvest at the higher rates.

Safety in Action

During the three-month period ending August 27, 2007 Vanguard Short Term Treasury Fund (VFISX) had a total return of 2.19% and Vanguard Short Term Federal Fund (VSGBX) had a total return of 1.72%—exactly the ballast desired in a credit crisis. Bond funds that took on significant credit risk to provide outsized returns, however, performed poorly and contributed to the decline in portfolios this summer.

The lesson is clear. Bonds are not for juicing your returns. Homeruns come from stocks. Bonds are for playing defense and for moving the runners along slowly—with bunts and singles.

High-quality, short-term bonds best serve that purpose. If you are holding “generic” bond funds—or aren't sure what you're holding—take some time to review your bonds lineup. Make certain that the percentage of your portfolio you and your adviser have dedicated to fixed income is doing the job: reducing risk and smoothing out big swings.