GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

Will Ignoring Bonds Help You Sleep Better at Night?

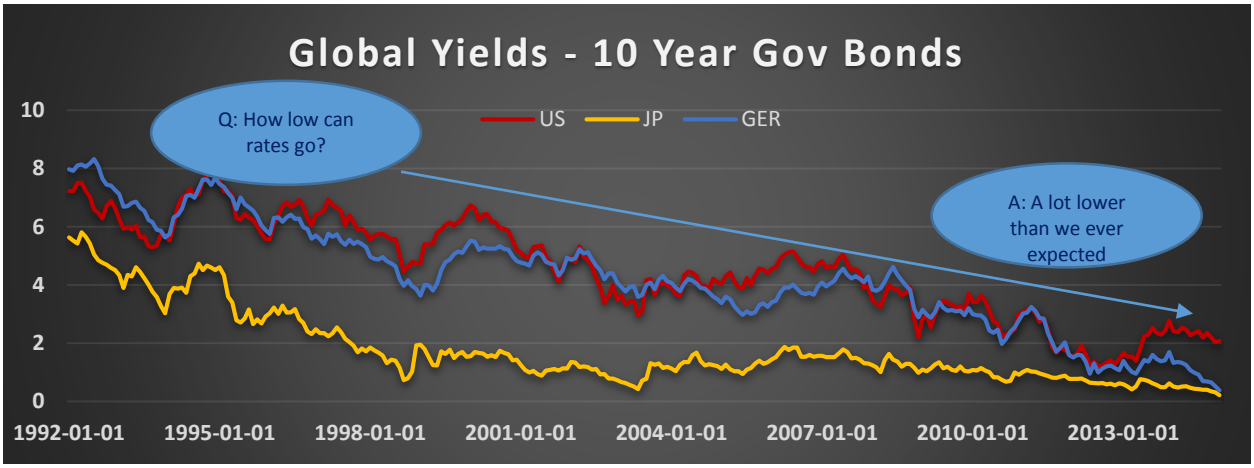
With interest rates hovering near recent memory lows it is tempting for investors to turn in disgust and ignore the fixed income markets and focus instead an asset classes with more potential for outsized returns such as stocks.

While such a reaction is not unreasonable for an investor with a time horizon measured in decades (after all stocks do tend to outperform bonds over the long-term), for investors with more immediate goals and cash flow needs the inclusion of bonds in their overall asset allocation mix is worth exploring in greater depth.

The Role of Fixed Income in a Portfolio:

Historically, the role of fixed income in an asset allocation mix has been income generation. In an environment of higher interest rates investors could count on their coupon income and anything beyond that was pure gravy. As shown in Figure 1 declining interest rates have been with us for a while now and the problem is not confined to the US alone. Fixed income investors in the US should feel relatively better than their Japanese counterparts who have seen yields plummet to levels never previously imagined. As we all know, bond markets have failed to generate the income traditionally expected from this asset class, but does that mean that bonds have become totally useless?

Figure 1



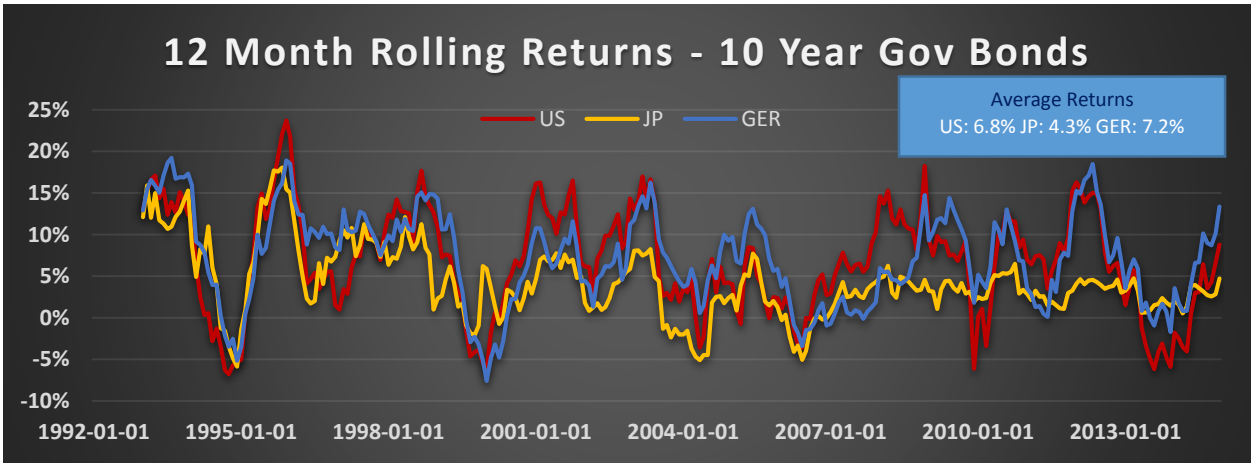
Thinking of Bonds as More than Just a Yield Play:

The answer to the above question involves a lot more than simply looking at yields. As a first step, while bond investors have seen their coupon income erode, they have more than made up for this shortfall through price appreciation. That is because as interest rates decline the value of a bond rises.

Look at the rolling one year returns to bond investors holding 10 year government bonds shown in Figure 2. The total return to bond holders in the US has averaged 6.8% since 1992. German bond investors have, on average, had even higher returns at 7.2% over this time period and even, poor yield-starved Japanese investors have had an average return of 4.3%. While there have been periods of losses, bond investors, in general, have had more good rather than bad times over the last couple of decades despite aggressively falling yields. Even Japanese investors must be quite happy with the performance of their bond holdings.

However, there is a limit to how low interest rates can go and thus price appreciation gains are capped at a certain point. We may be at that point now in the global economy but in all honesty we have been saying that rates are too low for a while now. We are in good company, however, as we scratch our heads trying to figure out along with some very well-informed strategists how to explain these long-term interest rate declines - a problem that former Fed Chairman Allan Greenspan referred to as a "conundrum" in front of Congressional testimony back in 2005.

Figure 2



Expanding the Role of Fixed Income to Include Other Activities:

Our base case scenario at Global Focus Capital calls for slowly increasing long-term interest rates over the next couple of years in the US, but rather than predict where interest rates might be in the future, maybe a more useful exercise for investors is to focus on the "other" benefit offered by their fixed income investments. If you are not getting a lot of income from your bond investments and now you are telling me that future price appreciation is iffy at best, what might that "other" benefit be?

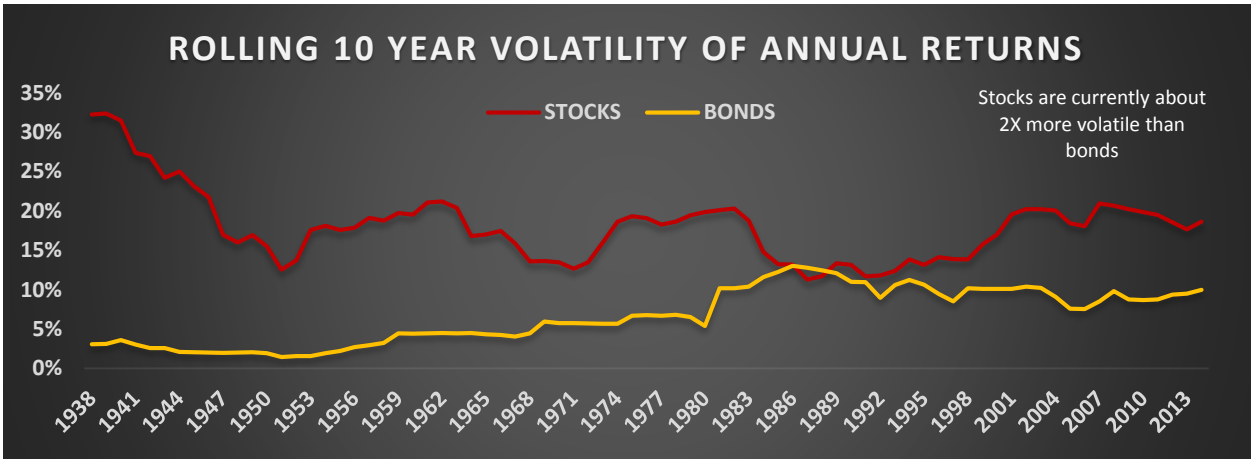
The "other" benefit of holding bonds in your asset mix is usually associated with getting a better night's sleep or at the very least taking a lower dosage of Ambien. What I mean by this is not being as worried about the daily changes in the value of your portfolio. Bond allocations especially in the context of an equity tilted asset mix will significantly dampen the volatility of a portfolio and make you less dependent on Ambien for a good night sleep.

Why would bonds help deal with the craziness of global capital markets? The answer has two parts – the first deals with the inherently lower risk of bonds and the second involves how stocks and bonds behave in relation to each other.

Let's examine the first part of our answer. Bonds, in general, exhibit significantly less day to day volatility than, say more aggressive investments such as stocks. For a historical perspective see Figure 3 where we depict the rolling ten-year return volatility of US stocks and long-term US government bonds. As shown in the chart, there has only been a short period of time (culminating in 1986) when the two asset classes had roughly equal levels of volatility. This came after a tumultuous bout with inflation during the 70's and early 80's and a sudden radical change in Fed policy under Chairman Volcker.

Even though in reality most fixed income investors do not hold such a long maturity bond as depicted in Figure 3, historically the volatility of annual long-term bond returns is roughly 7% while that of stocks stands at 18% per annum. During the recent ten year period, the ratio of volatility of stocks to bonds is roughly 2X. What this means is that in any given year the returns to bond investors will likely fall within a much tighter range than the returns to stock allocations.

Figure 3



There are good reasons why bond returns are less volatile than stocks. The finite life of a bond plus the contractually promised (barring default, of course) nature of coupon payments and principal repayment provides a floor to the amount of risk taken by the investor. In comparison, the common stock of a company provides no such guarantees and in the event of bankruptcy, equity holders are last in line to get what's left over after creditors including bond holders are paid off. Bondholders may lose it all in a bankruptcy, but in other less unpleasant scenarios their risk is

contained. Of course the old saying "less risk, less reward" rings true and that is why, on average, bond investments tend to under-perform stocks but with much lower levels of risk.

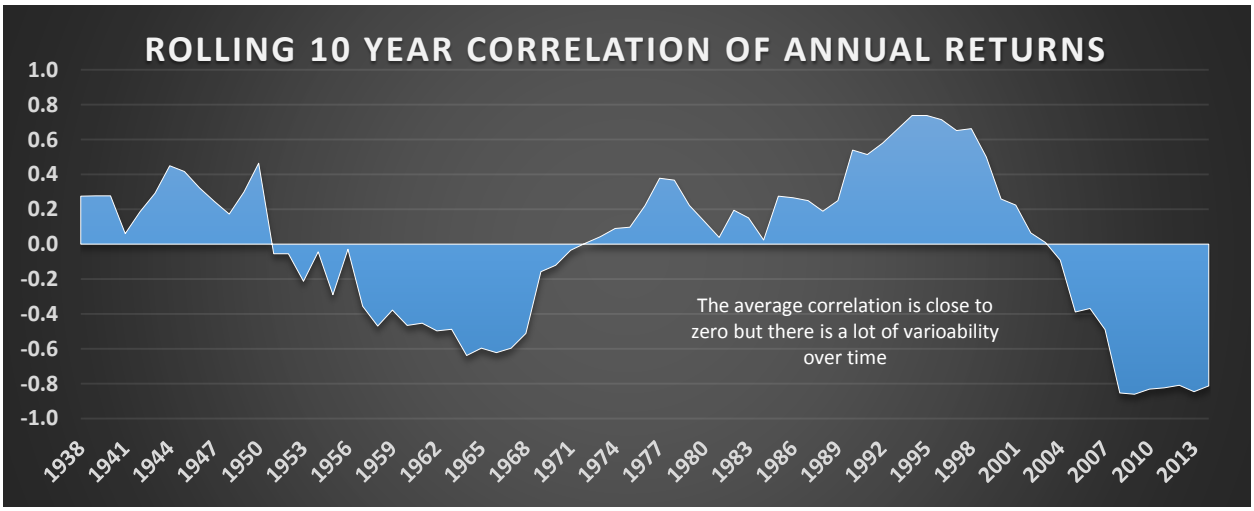
Moving on to the second part of our answer as to how, despite low current coupons and potentially capped price appreciation, bond investments can still be beneficial to your portfolio and allow for a better night's sleep we turn our focus toward how stocks and bonds typically behave in relation to each other.

Historically, stocks and bonds have been the two mainstay asset classes for investors. Traditionally, equities have been the "growth" asset and bonds the "income and security" asset class. As we have already explored, in recent times bonds have lost most of the "income" component and now we must rely on the "security" component. As previously mentioned, bonds are significantly less volatile than stocks and thus provide "security" to the overall portfolio.

But there is yet another dimension to this "security" aspect and it involves how bonds and stocks typically interact with each other. While the average correlation between stocks and bonds is historically close to zero (see Figure 4) there are long periods of time such as the post 2000 when the correlation is negative indicating that when stocks do poorly, bonds should do better than average.

The offsetting behavior of stocks and bonds is most apparent during periods of extreme stock market performance. Taking the ten worst years of S&P 500 performance since 1928 we observe an average return to stocks of -23.8% while long-term US government bonds returned, on average, 5.3%. In the 24 years since 1928 when the S&P 500 has had a negative annual return only in three of those years (1931, 1941 and 1969) have long-term bonds similarly showed a loss (averaging -3.2%). Clearly, bonds have historically provided significant downside protection to riskier portfolios composed of stocks.

Figure 4



Examining Some Potential Capital Market Scenarios:

Even during periods of positive correlation, stock investors should, under most conditions, be able to improve the reward-to-risk ratio of their portfolios by including bonds in the mix. Let's examine some likely scenarios and perform what we call a break-even analysis on bonds. Technically speaking we are searching for the rate of return to bonds necessary to improve the reward-to-risk tradeoff of a portfolio.

Let's say that our current portfolio has an expected return of 8% per year and a volatility of 14%. These assumptions would be reasonable for, say, a US large capitalization equity portfolio such as the S&P 500. Assuming short-term rates at 0.5% and a volatility of bonds of 7% what would be the required rate of return to our bonds to justify including them in our hypothetical portfolio?

Without getting into all the technicalities of modern portfolio finance the answer depends on the assumed correlation between our hypothetical portfolio and bonds. Table 1 illustrates our assumptions and calculated break-even rates of return to bonds under three scenarios. Case A is representative of today's environment of negative correlation between stocks and bonds, Case B is representative of the long-term history (zero correlation), and Case C most closely conforms to the equity bull market run of the late 80's and 90's in the US.

Table 1

SCENARIO	PORT RET	T-BILL RATE	VOL PORT	CORR PORT,BONDS	VOL BONDS	BREAK EVEN RETURN
A	8%	0.5%	14%	-0.30	7%	-0.63%
B	8%	0.5%	14%	0.00	7%	0.50%
C	8%	0.5%	14%	0.30	7%	1.63%

What Table 1 shows is highly revealing. In order to improve the return-to-risk profile of the hypothetical portfolio under Case A (a scenario that applies to today's markets) an investor should be willing to include bonds in the asset mix if the return expectation is greater than -0.63%. In other words, you might take a loss on your bond allocation to improve the overall return-to-risk profile of your portfolio.

This does not make much sense to most investors, but think of bonds, under this scenario, as providing "insurance" to the portfolio. The lower volatility of bonds and negative correlation to the hypothetical portfolio provide such overall risk reduction benefits that the break-even rate for holding bonds is actually negative.

Just like buying insurance on a house is often a yearly money losing proposition, the same can be said of holding bonds despite very low or even negative expected rates of return. You buy insurance on a house to cover all 365 days of a year because you never know when a disaster might strike and the same can be said of holding bonds along riskier investments in the face of potentially rapidly deteriorating capital market conditions.

Moving on to the scenario most representative of long-term capital market conditions (Case B) yields a break-even rate of return on bonds of 0.5% per annum. As for the previous case, the risk

reduction benefits of adding bonds to the asset mix are significant. However, without the benefits provided by negative correlation, in this case the investor will require an expected return to bonds north of 0.5%. Not a high hurdle to overcome, but investors are no longer willing to pay for the insurance. Assuming an investment in a 10 year US government bond currently yielding 2.02% you would need only a 0.2% increase in yields to drop the one-year return to 0.5%.

Finally, moving to the case where stocks and bonds are positively correlated (Case C), the break-even bond return jumps up to 1.63%, not far from where the 10 year US note currently sits. A tiny increase in interest rates of 0.0005% will result in capital losses of 0.4% which coupled with the coupon will yield a total return in line with the breakeven rate. Not counting on the benefits implied by a negative stock/bond clearly diminishes the portfolio diversification value of allocating money to bond strategies.

Focusing on the Total Benefit Package and Managing Your Total Portfolio Risk:

While predicting interest rates is one of the hardest forecasting tasks that we have ever undertaken and even insiders at the Federal Reserve can at times face their own "conundrum" a couple of things are worth bearing in mind before chucking out bonds from the asset mix in the face of the extremely low interest rates prevailing in today's capital markets.

First, bonds will very likely exhibit lower levels of volatility than stocks. This feature will allow you to sleep better at night. Stocks are more exciting to own and when times are good they are really good. But, the higher risk of stocks comes at a high price especially during those albeit infrequent market meltdowns. Bond allocations are a godsend during those times when capital preservation becomes paramount.

Second, the correlation between stocks and bonds is, at the moment, solidly in negative territory. While correlations do change over time, the pace of change is often slower moving than implied by the craziness of capital markets. The current negative correlation between stocks and bonds could flip in sign and become positive, but we doubt it at least over the next few years.

Assuming that the next Federal Reserve move is to raise short-term rates in the US our base case scenario is for bond markets to initially suffer some short-term capital losses. The Federal Reserve only has marginal power over the long-end of the yield curve and other factors such as demand from foreign providers of capital and inflationary expectations are more impactful. If anything, our expectation is for foreign demand for US debt to persist as US yields still offer a pickup over those of most developed economies. In addition, global inflationary pressures will continue to be contained given declining commodity prices, higher than average rates of global unemployment and ample spare capacity. Both of these developments should provide a cap on significant future interest rate increases.

Our view at Global Focus Capital is that bonds while not as attractive as in the past still offer significant benefits in the context of a portfolio containing higher risk assets such as stocks. We recommend looking at the total benefit package offered by bonds and managing the total portfolio risk.

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