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# The Benefits of Bonds


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**Why Bonds?**

1. *Bonds, otherwise known as fixed-income securities, can help provide competitive, if not superior,* ***total returns*** *in certain market environments.*
2. *Bonds* ***diversify*** *equity-dominated portfolios.*
3. *Bonds* ***produce income*** *streams.*

Frequently, many investors overlook the benefits of bonds. Many times it is not a deliberate decision, rather it is one of a lack of familiarity, comfort or understanding of the great many benefits that bonds have to offer. Everyone knows how to make money (or lose money) by investing in stocks – it seems so basic: buy a stock at $10 per share and if it goes up to $13 you have made a tidy little profit in percentage terms. Because it is not so quick or transparent, the way to make money by investing in bonds is often misunderstood. But rather than focus on the total return (trading for a gain) aspect of bonds, maybe it is better to think about the bigger and more important role of bonds in a portfolio and the tremendous benefits they offer. As one study points out - "finance theory does offer a free lunch: the reduction in risk that is obtainable through diversification. An investor who spreads wealth among many investments can reduce the volatility of the portfolio…" Yet we have found over the years that many investors take a pass on the free meal.

We believe that well-balanced, diversified portfolios will offer superior risk adjusted returns over time. One of the easiest and most common ways to diversify an equity-dominated portfolio is through fixed income investing. Fixed income investing not only helps reduce risk in a portfolio, it also provides income that can be either taxable, tax advantaged or tax-exempt and provide a way for investors to ride out otherwise unattractive investment cycles and options that are inherently more volatile. An allocation to bonds should be viewed as a component of a complete portfolio.

As for how much an investor should hold in bonds, that depends on a variety of factors, including investment objective(s), time horizon, risk tolerance, and other unique considerations.

**A few commonly asked questions:**
***Q: What exactly is a bond?***

A: A bond is essentially a loan and bondholders have a promise of repayment from the borrower. It is a debt security, issued by a corporation or government, with a stated interest rate (coupon rate) and fixed maturity date when the principal must be paid back. The coupon payment dates usually occur every six months. Typically they trade in denominations of $5,000 face value for municipal bonds though Treasury, agency and corporate bonds have varying minimum sizes.

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***Q: Why are bond yields low?***

A: Bond investors generally take on a lot less risk than equity investors and bond yields are reflective of those lower risks.

There are years when equities produce stellar returns just as there are others when they produce stinging losses. The last big down year was in 2002 for example. The S&P was down 22% while bonds (Lehman Aggregate Bond Index) were up 10%. If an investor had a total portfolio of $100k split evenly between the S&P and the Lehman Agg they would have lost a total of $6,000 that year instead of the $22,000 the investor who was 100% in stocks would have lost. Some investors have higher risk tolerances and accept the higher portfolio risk for the chance to earn higher returns. For others, they know that they are still participating in the equity market but with less total exposure due to the diversification benefit realized by adding bonds to the mix.

***Q: How are bonds traded?***

A: Bonds trade on a yield basis first and then are converted to a dollar price. When yields go up, dollar prices go down. When yields fall, prices go up. Know that a five-year bond bid at a yield to maturity (YTM) of 3.00% equates to a higher dollar price than the same bond bid with YTM of 3.20%. Bond math can be confusing but understanding it all begins with this basic premise.

If bond yields rise in the marketplace and you already own bonds, this does not mean that you are losing income. Although your month-end statement might show a decline in market value of your bonds, the income, which is based solely on the face value, remains constant. Over the life of a bond there are going to be times when the market value may be higher or lower than what you paid. In the end, on the last day you receive the face value back plus the final interest payment.

***Q: All of this seems so confusing. Why not just keep my money in cash, CDs, or money market funds?***

A: It can be confusing at first. That is why it is important to understand what you are doing when investing in bonds. Once you do understand and accept characteristics of bond investing, you should be better suited for the commitments you are making.

As for money market funds, bonds tend to offer much better returns than a pure cash money market but should never be confused with or used in place of one. Bond prices rise and fall and if an investor chooses to sell a position before the bond's maturity date then he is subject to the price fluctuations that are part of any market and investment cycle. Money market funds offer dollar in, dollar out daily liquidity. While most bonds are liquid and trade without limitation there can be periods when they don't trade. Bond investors take on more risk than money market fund investors and receive higher, locked in rates of return for that commitment.

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In short, funds for short-term liabilities should be in cash. For long-term investors, however, bonds offer higher total returns over time than cash.

***Q: Will I get all my money back when I invest in bonds?***

A: The odds are very high that an investor in high quality, investment-grade bonds is going to see a return of all of his money – plus interest of course, at a future date. Default rates in investment grade bonds are very low – even lower in municipal bonds. Less than 1% of the muni market (a market that is about $5.6T in total size) defaulted in a study that goes back to 1980.

If a company were to declare bankruptcy then the capital structure hierarchy is worth knowing. Bond investors get paid first. Senior bonds, then subordinated holders follow them. Next come the trust preferred investors, preferred stock and finally the common stock holders.

***Q: What about bond ratings? What is good and what isn't?***

A: The highest rating an issuer can attain is "AAA". Generally the higher the rating the more secure the bond is thought to be. Investment grade rated bonds carry a rating of "BBB-"or higher. Bonds rated below this level are considered to be speculative and carry more risk.

Answering what is "good" is a bit more involved because good is a matter of perception defined by the individual investor. Bonds do carry ratings from a number of raters but the two biggest and well known tend to be Moody's and Standard & Poor's. Less risk averse bond investors might feel comfortable with a single "A" rated bond while others may prefer only the highest quality available and settle for nothing less than "AAA" rated bonds. Of course, the investor in the "A" rated bond will likely receive a higher yield than the investor in the "AAA" rated bond.

***Q: How have bonds performed in recent years?***

A: Bonds have performed very well over the past 10 years. Our table below shows just how well over the past ten years on an annualized basis. Hopefully this dispels the perception that bonds "always" under-perform equities. Of course, past performance is no guarantee of future performance but we remain bullish on the diversification benefit bonds add.

| Index | 10 Year Return 4/30/08 | Std Dev 10 Yr |
|---|---|---|
| LB US Treasury US TIPS TR USD | 7.70 | 5.27 |
| LB US Agg Bond TR USD | 5.96 | 3.48 |
| S&P 500 TR | 3.89 | 14.75 |

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***Q: If bonds reduce portfolio volatility in multi-asset portfolios, exactly how do bonds "correlate" with other investments?***

A: "Correlation" is a statistical measure how two securities move in relation to each other. Perfect positive correlation (+1.0) suggests that as one security moves, either up or down, the other security will move exactly in the same direction. Perfect negative correlation (-1.0) meanwhile, means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. Obviously, greater diversification benefits can be realized from lower, if not negative, correlations. Do realize, however, that correlations are dynamic and change over time.

The correlation table below demonstrates how un-correlated high quality / investment grade rated bonds are to equity indices. The negative correlations of the major fixed-income indices are the primary take-away point that stands out from the information below. (Note: there is nothing special about the beginning date of September 2001 – this was the point where our data begins for the Lehman Brothers TIPS Index).

**Correlations: Sept 2001 - May 2008**

| | LB TIPS | LB Muni Bond | LB Agg. | S&P 500 | Cash |
|---|---|---|---|---|---|
| Lehman Bros TIPS | 1.00 | 0.68 | 0.84 | -0.25 | 0.19 |
| Lehman Bros Muni Bond Index | 0.68 | 1.00 | 0.72 | -0.17 | 0.13 |
| Lehman Bros Aggregate Bond Index | 0.84 | 0.72 | 1.00 | -0.27 | 0.20 |
| S&P 500 Index | -0.25 | -0.17 | -0.27 | 1.00 | -0.11 |
| Cash | 0.19 | 0.13 | 0.20 | -0.11 | 1.00 |
| TIPS = Treasury Inflation Protected Securities | | | | | |

***Q: What about "premium" bonds? Why would I ever pay above $100 for a bond when it will mature at $100? Won't I be taking a loss?***

A: This is the next step in understanding bond math. Once again – bonds trade on a yield basis first. If a five year muni bond with a natural "AAA" rating is worth a rate of 3.00% then that is the first characteristic to focus on. If it is offered with a yield of 2.90% know that it is over-priced. If you can find one offered at 3.10% know that it is a good bargain.

Premiums do not necessarily mean losses. Any premium paid will be paid back to the investor gradually over the life of the bond if held to maturity. It comes back to you bit by bit every six months in the form of interest payments. The reason the bond trades at a premium dollar price is because its coupon is higher than its yield to maturity. You pay the premium in order to receive higher coupon payments. Often times the investor in a premium dollar priced

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bond will pick up a little extra yield to help compensate. Premiums need to be understood. If an investor is withdrawing all of the income the bond produces then that is effectively spending down the principal by the amount of the premium paid.

***Q: What are "callable" bonds?***

A: A callable bond means that the issuer holds an option, at their discretion, to redeem the bond at a date prior to the stated maturity date. Usually they would do this if their cost to borrow money in the bond market falls.

Think of it this way: If you had a 30-year home mortgage at 7.00% and rates fell a year later to 6.00% you could refinance your loan, pay a lower rate and realize and interest expense savings. Bond issuers have the same ability to refinance and lower their borrowing costs. However, bond issuers do typically have to wait a period of time before they can "call" bonds. In the muni market new issues typically come to market with a standard 10-year call protection agreement for the investor. This means that if you invest in a new issue bond with a fifteen-year maturity that you are guaranteed that the issuer won't call the bond for at least ten years.