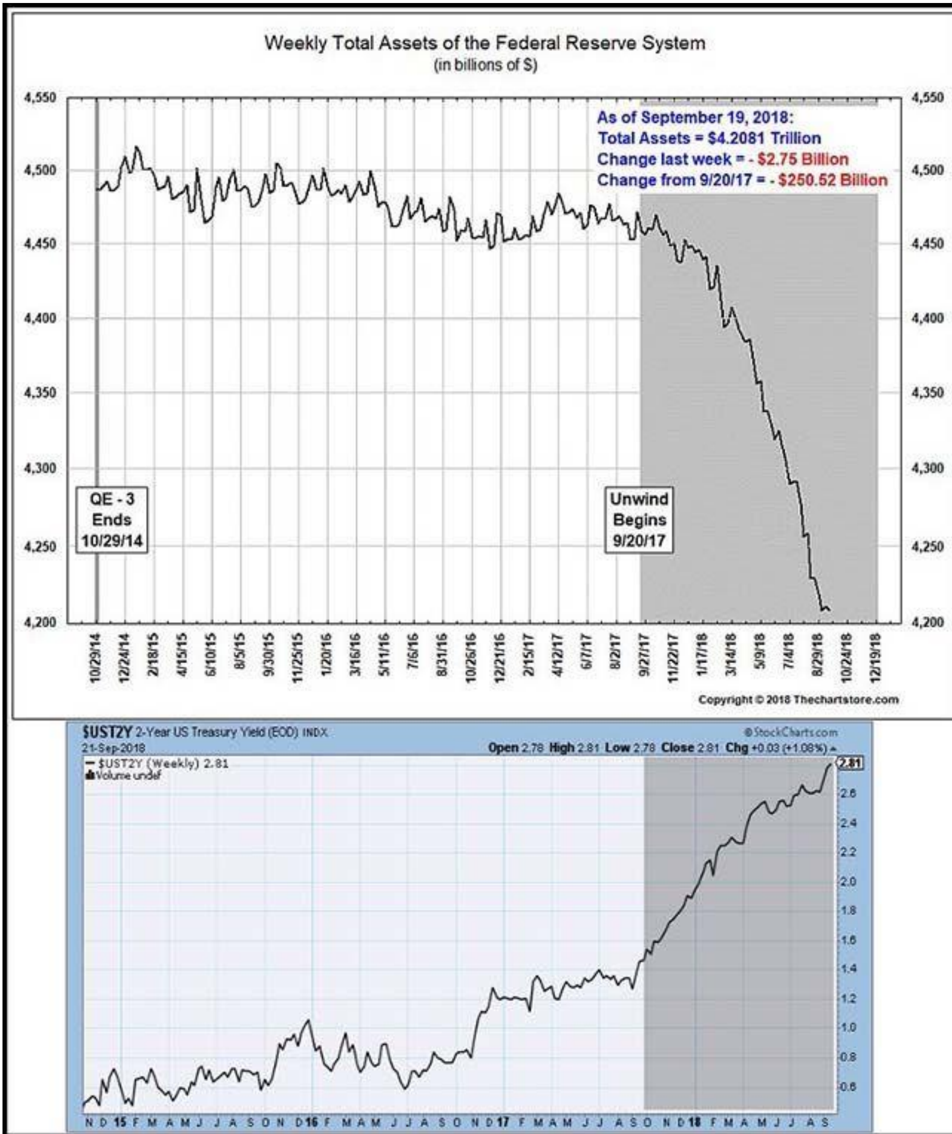
What to do about bonds – should you own them?

Conventional wisdom suggests that any investor in middle age or older should own some bonds in their investment portfolio. Bonds tend to help diversify a portfolio and bonds tend to be less risky in terms of drawdown and loss of principal when compared with other asset classes. A 50 year-old investor might typically own between 30% and 60% bonds depending on how aggressive an investor they are. The US bond market is in transition. After a 35-year bond Bull market, we are now likely headed for a long-term bond Bear market as interest rates move higher and bond prices move lower (bond prices and yields move in opposite directions). The two main risks to bondholders, interest rate risk and credit risk, are both very relevant considerations in today's environment. This article will discuss current considerations for each type of risk and suggestions for mitigating those risks.

During the bond Bull market, bond holders received the bond coupon (interest rate) plus capital appreciation (as older, higher-yielding bonds became more valuable), going forward, bond holders are likely to receive only the coupon. If interest rates move higher, there is a real risk that investors will experience a capital loss in bonds if they need to sell the bonds before they mature. For each 1% rise in interest rates, the expected decrease in a bond's price is approximately the % rise times the duration. So a newly issued 20-year US treasury bond could lose approximately 20% of its value after a 1% rise in interest rates[1]. Most people do not expect to experience a capital loss on their US treasury bonds! We are talking about interest rate risk – a very real and tangible risk in bond investing but a risk that is returning after a several-year hiatus.

Aspen and other active portfolio managers have been steadily shifting toward short-term debt, which is less vulnerable to losses from rising rates and inflation. The average actively managed taxable bond mutual fund has a duration of 3.6 years according to research from the Investment Company Institute (ICI) (see figure to right). Meanwhile, passive index mutual funds have an average duration of 6.2 years. The increase in passive fund duration is largely due to the fact that the indexes are designed to reflect the broader market, including U.S. Treasury debt. The U.S. government has issued more debt since the financial crisis to pay for things like bank bailouts, unemployment benefits and tax cuts, so Treasurys have become a larger slice of the indexes. Treasury debt tends to be

[1] This is a "rule of thumb" approximation; complex formulas are available for precision.



longer term than corporate debt, which has dragged duration higher. U.S. Treasurys are now 38.1% of the Bloomberg Barclays Aggregate Bond Index, up from 22.4% at the end of 2007, according to ICI[2]. Increasingly over the past few years, more and more money has been invested into passive bond funds that track an index like the Barclays Aggregate index. Most investors are probably unaware of the interest rate risk they are facing in such investments (individual bonds or funds).

Changing policies at the US Federal Reserve are one of the main contributors to interest rate risk. Quantitative Easing (QE) is giving way to Quantitative Tightening (QT) – the punch bowl is being taken away and interest rates are rising (see figure to left). The US Federal Reserve Bank is no longer buying Treasury bonds and mortgage bonds and thus the Federal Reserve balance sheet is unwinding from all-time high levels of *$4.5 trillion.* At the same time, the U.S. Treasury Department estimates it will issue more than $1 trillion in debt this year as higher government spending and sluggish tax revenues push the deficit higher[3]. This combination of the government no longer buying bonds to support the market (QE) and simultaneously introducing massive supply of new bonds to the market serves to push interest rates higher as non-government buyers demand a higher return for funding the government.

The other major risk associated with bond investing is credit risk – the risk that the borrower will not repay his debt in full. This was the main element of risk in the mortgage bond crash of 2008-9. This time around, mortgage bonds are not the main concern; increased corporate and sovereign debt are the concerns.

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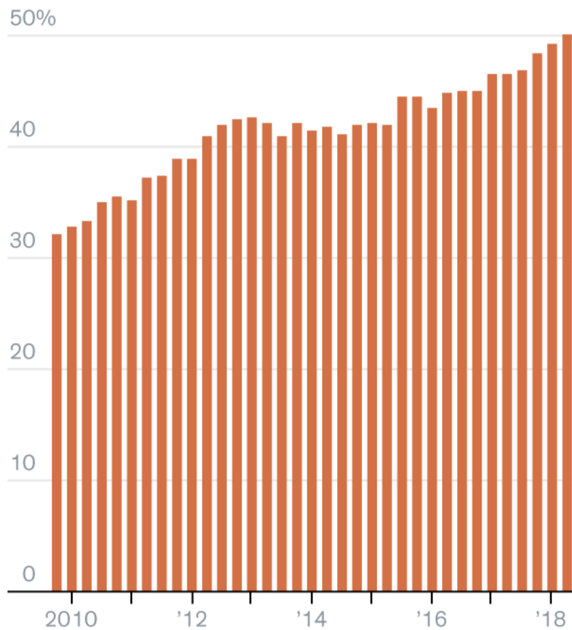
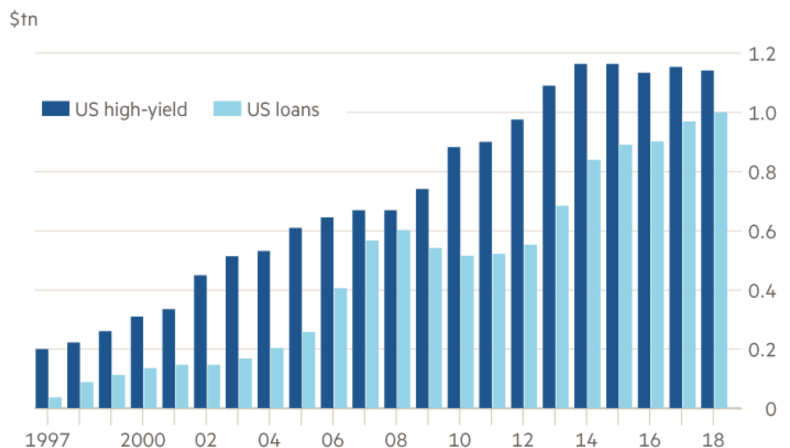
[2] Wall Street Journal 11/1/2018

[3] Wall Street Journal 10/20/2018



Many investors think of all investment-grade debt as low-risk, unaware that BBB credits (the lowest tier of investment grade) now make up nearly half of the $6 trillion investment-grade world (see figure to left). In contrast, in 2008, amid the financial crisis, they accounted for less than a third of the total, or $700 billion. The BBB crowd isn't just bigger now; it's also riskier. Since the crisis, leverage, measured by debt divided by annual average earnings before interest, taxes, depreciation, and amortization, or Ebitda, has increased markedly for BBB credits. It now averages 3.2 times Ebitda—a gauge of cash flow—compared with 2.1 in 2007. A record 37% of companies have debt that is five times or more their Ebitda[4]. According to Joe Kalish of Ned Davis Research, the deterioration of credit quality means the corporate debt market is in a worse position to cope with a recession than it was on the eve of the 2008 financial crisis. At $3 trillion, the BBB market is almost triple the $1.2 trillion junk bond market.

Another category of investible debt is bank loans or "leveraged loans" which have grown to be a $1 trillion asset class. These are floating rate loans to companies who often are already indebted, are unable to sell more bonds and have low credit ratings. Since 2010, the leveraged loan market has doubled in size from $500 billion according to Bank of America Merrill Lynch[5]. Leveraged loans are attractive because they pay high interest rates which also adjust higher as market rates move up as the Federal Reserve tightens (raises short-term rates). Typically, loans have covenants and restrictions that must be abided by. Covenants are lender protections in a bond or loan document that can limit the amount of debt a borrower can take on or how much it can pay its equity investors in dividends. Right now roughly 78% of the more than $1 trillion in outstanding U.S. leveraged loans are covenant-lite, compared to just 29% in 2007, at the peak of last credit cycle (and just before the financial crisis)[6]. For debt owners (holders of bonds & loans) these covenants protect the cash available to be paid out as interest.



[4] Barrons 8/17/2018

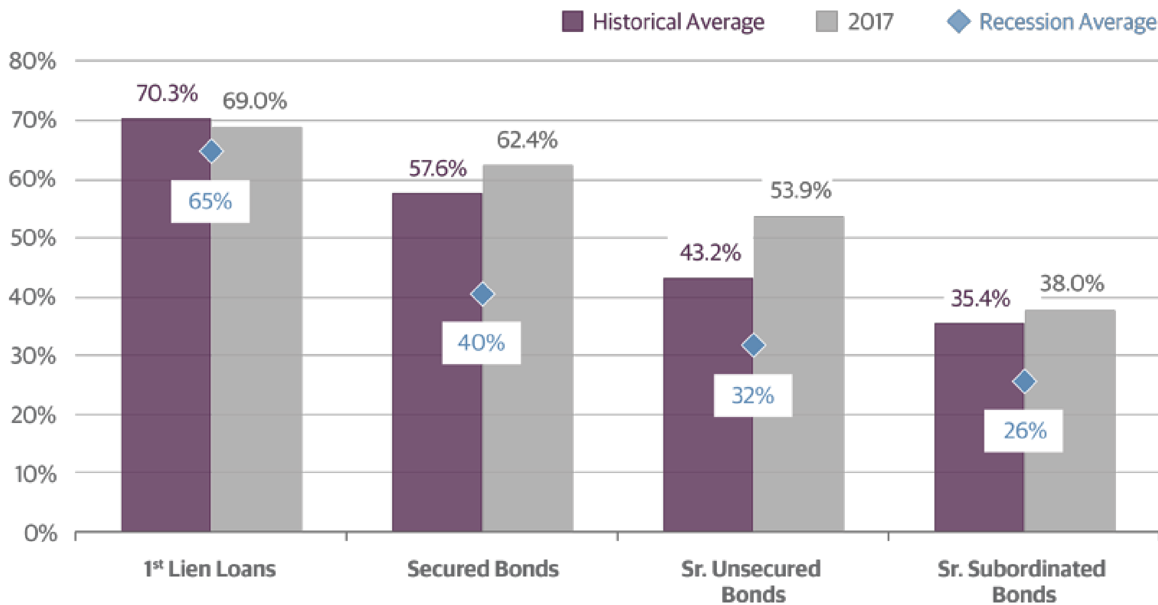
[5] The Financial Times 5/3/2018

[6] Leveragedloan.com 7/23/2018

Ok, so there is more risky debt now than there was in 2007. But how bad can it get from an investment point of view? During the last 3 major US recessions (1990-91, 2001, 2008-9) high yield bond and leveraged loan debt defaults ranged from 11 to 14%. The recovery rates on those defaults were a low of 53.4% for loans and 15.9% for the lowest-rated junk bonds[7]. So in the historical "worst case", if 14% of an investor's speculative grade credit goes into default and he realizes a mere 15.9% recovery on those defaults, he stands to lose 11.8% (14% x (1-15.9%)) of his principal on the average basket of loans and junk bonds. Additionally, the loans and bonds that do not go into default will likely lose value in a recession as their yields shoot higher as their market prices decline. These principal losses would be somewhat offset by interest received from the loans and bonds owned that did not go into default. As a real-life example, in 2008 some well-regarded floating rate loan funds from Lord Abbett and Blackrock lost 21% and 29% respectively; the category was down 30%[8]. The good news is that the losses were recovered in a little over a year. The following table illustrates the average recovery rates for different types of debt, in declining order of seniority, since 1990.

When times are good, owning the lowest rated debt (junk bonds and loans) can be rewarding in terms of high yields and corresponding interest payments. However in stressful economic times like a recession, such low rated debt can be costly in terms of capital losses. As illustrated from historical results, the probabilities of a double-digit principal loss in such debt are high when we have our next credit crisis &/or recession. If such a loss in your retirement portfolio would be worrisome, now may be a good time to mitigate risk.

Historical Average Recovery Rates from Original Value (1990-2017)[9]



[7] Moody's Investor Service February 15, 2018

[8] Per Morningstar

[9] Guggenheim Investments High-Yield & Bank Loan Outlook Report 4/12/2018

So what is a bond investor to do? We believe that bonds continue to be an important component of a diversified portfolio, but choosing the right bonds is perhaps more important today than it has been for a long time. To mitigate interest rate risk, one should invest in shorter duration bonds and floating rate bonds and loans. To mitigate credit risk, stick to high-quality investment grade bonds rated "A" or better (A3 by Moodys & A- by S&P or Fitch) and senior, floating rate loans in secured, first-lien positions from sound companies with minimal risk of bankruptcy. The good credit-risk companies rarely default on their debt (less than 0.5% for "A" rated debt in 2008-9)[10]. However during stressful periods such as recessions, even the highest-rated corporate debt can decline in value and if you are forced to sell some of those bonds before they mature, for example to pay bills, you will incur a capital loss. Remember that when bonds mature, you get "par value" or full price for those bonds. If you expect to have cash liquidity needs over a period of time, say 5 years, buying bonds and loans with varying maturity dates (also known as laddering) can help address those cash needs and at the same time, mitigate capital losses.

Whether to own bonds and if so, which ones, is a personalized decision and depends on one's investment objectives and tolerance for risk.

As always, if I can help with any of your needs or questions, please feel free to call (913) 491-0500 or email steve@aspenwealth.com.

[10] Moodys Investors Service Annual Default Study 2/15/2018