NOVEMBER 2017

Is it finally time to scuttle your bond funds?

For years now, professional investors have been telling us to stay short term on bonds as U.S. interest rates were going up. Well, they've been wrong for the last ten years, although, as the Wall Street saying goes, even a broken clock is right twice a day!

9/11 and the Great Recession have conspired to make the first decade of the 21st century another downhill roll for interest rates. Here in 2015, there appears to be no uphill yet in sight, even though the Federal Reserve is keen to start raising the short term rates they control.

In fact, recently the market has deduced that the Fed will increase rates in December. The outflows from bonds funds have increased on that realization, as investors are scared that the overall increase in interest rates will hurt the principal value of their bond holdings. Are they correct in pulling their money out of bond mutual funds?

Yes, but possibly for the wrong reasons. As interest rates have fallen over the last twenty years, bonds have had much "wind in their sails" and have generally appreciated in price. In fact, most bonds today sell at premium prices to their par or maturity values as lower overall interest rates have pushed bond prices much higher. Therefore, when the bonds mature, there will be a loss of capital as the premium pricing seen in today's market reverts to the bond's par value (usually $1000).

An increase in interest rates will cause the premium prices to evaporate more quickly than normal. For investors holding individual bonds, this is somewhat of a non-issue as the investors were aware of the premium as the bonds yield-to-maturity stated at purchase included this amortization of premium. Most bond investors plan to hold until the bond matures. What, however, is the maturity date of a bond mutual fund>? The answer is most do not have one. Mutual funds are infinitely-lived and do not mature but continue in perpetuity. Therefore while an investor may know the current yield of a bond fund, there is no way to calculate what the actual yield-to-maturity will be. The same is true of a bond index. Put another way, bond funds are not really "fixed income" as there is no way to know what the return will be one, two, or many years into the future.

Here in 2015 (through Nov 12) using the Morningstar database of mutual fund returns, we see bond funds returns as high as 3% for some specialty funds, 1.83% for the intermediate corporate bond index and only 0.50% for widely held funds like Pimco Total Return. Those returns are already below the average coupon in those funds (3.9% for Pimco) , so the rapid amortization of premiums has begun.

What can we expect then if we do indeed get an interest rate hike from the Fed? One likely event would be an even more rapid amortization of bond's premium prices. With returns in the 0.5% to 3% now, what can we expect going forward from those same bonds funds? It is quite likely that the more rapid amortization of premium in bond fund holdings will consume much of the income received from those holdings. Which begs the question of, how long will it last?

Unlike 2013 where we saw a "flash crash" or temporary interest rate spike, this will be more of a "smoldering fire" where it is no longer a temporary setback, but a permanent impairment of capital which may or may not exceed the coupon payments received. Therefore, under those conditions, one might reasonably expect a total return from the average bond fund of somewhere in the -1% to -2% range over the next few years. The effect of the rapid evaporation of premium will initially weigh on returns, while eventually the more normal effect of rising rates depressing bond prices will have its more lingering and permanent impact.

Stock investors accept the risk of holding stock, and the likelihood of negative returns once in a while, for the potential to make two to three times the rate of inflation over the long run on their investments. Bond investors, on the other hand, would be happy to pace inflation with their 'safe' bond holdings. Unfortunately for them, this may be nearly impossible in the next cycle.

There are many courses of action that a bond investor can take to mitigate this effect. One is to invest only in short term bond funds, accepting a much lower current yield, but also much less principal at risk of amortization. Still, there is no ability to calculate yield-to maturity. Another option is to dispose of the bond mutual funds and begin investing in individual bonds which indeed do have a yield-to-maturity calculation investors can rely on. Most individual investment advisors or brokers are not geared up to buy individual bonds for their clients. Yet a laddered or 'barbelled' portfolio of individual bonds does mitigate the risk and adds permanence and definition to the portfolio. Lastly, a strategy of buying much higher yielding preferred stocks, along with individual short term bonds may achieve the bond investors' goals of keeping pace with inflation and not suffering multi-year negative returns.

In any case, holding onto bond mutual funds and hoping for the best is no plan of action. You may ask your investment advisor to calculate the net present value of HOPE, or find one that can!

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