Investment Insights

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TANDEM
INVESTMENT PARTNERS

February 2015

Why do I Hold Bonds in My Portfolio?

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Over the past 18 months, we have received many questions about fixed income (bonds). Some investors have questioned the logic behind holding bonds with yields so low on a historical basis. The sharp spike in interest rates (and concurrent decline in prices of bonds) in the spring of 2013 also caused concern with investors who believed bonds were "safe" and could never lose value. Fixed income markets have been turbulent for nearly two years now, and we expect the volatility to continue into the foreseeable future.

In this Investment Insight, we attempt to provide a perspective on bonds. Tandem believes the correct question is not whether one should or should not own bonds, or should own fewer bonds. Rather, it is about what types of bonds to own as we expect rates to rise. Additionally, we explain why bonds deserve a place in all investors' portfolios and what we expect from bonds over the next few years.

First, we believe investors need to hold bonds as part of their total portfolio even when interest rates are rising. Bonds serve to provide stability, diversification and to reduce volatility in any portfolio. Bonds are a critical segment of a well-constructed portfolio. Although the Federal Reserve has not yet begun to raise interest rates – and has stated that it expects to maintain the near-zero policy rate for at least several more months – investor confidence in bonds has been altered to an extent. One concern relates to the very low current interest rates. Investors wonder if returns are going to be low on bonds during the next few years. Tandem believes the answer to that question is an unequivocal yes. If rates stay at the current low levels, you will collect a very low coupon yield. We believe that to be close to a best-case scenario. If yields rise from here (as we and many others expect), you may see lower total returns or even negative returns, depending on the amount interest rates rise and the duration (maturity) of your bond holdings. With that as the backdrop, many are wondering why they should continue to hold bonds at all.

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Tandem recommends that investors maintain a well-diversified investment portfolio consisting of bonds, stocks and cash reserves. We determine the proper percentages for each asset class on an individual basis, taking into account each client's unique objectives, age, income and other variables. We steadfastly believe that there is a place and a purpose for bonds in every portfolio even if that investment may produce a negative real return over a few years. The primary reason for owning bonds is to serve as a counterbalance to equities. Historically, bonds have frequently risen when stocks have declined, and vice versa. They have also been much less volatile than stocks and generate reliable income as an asset class.

While investors were shocked by the rapidity of the interest rate rise (and bond price declines) in 2013, we remind you that bonds are nowhere near as volatile as stocks. The largest calendar year decline for bonds (10-year US Treasury notes) was approximately 11% in 2009. Compare this to the 38% decline in stocks in 2008, and you can easily see why bonds are considered much safer than stocks. In fact, bonds have registered full year declines in only four of the past 25 years. The significantly lower volatility of bonds relative to stocks is one of the key reasons Tandem uses fixed income as ballast in portfolios. All investments carry some degree of risk, which is linked to the return that investment is expected to provide. From Capital Market Theory, we understand that generally, the higher the risk, the higher the expected return. Thus, safer investments offer lower returns. During the Financial Crisis of 2007-2009, as some stocks declined by 50% or more, high quality bonds rose meaningfully in price. This helped investors with bonds in their portfolios as it significantly reduced their portfolio losses. Balanced accounts at Tandem may have declined 12-15% or so, rather than 50% or more for investors that were 100% in equities.

Unfortunately, bonds are not currently generating meaningful amounts of income. Rates have declined over the past few months, with the 10-year US Treasury currently yielding about 1.80% - down significantly from the 3.00% early in 2014. Meanwhile, the S&P 500 index yields 2.0% and most high-quality equities increase their dividends on an annual basis. The Federal Reserve has stated on many occasions that it will focus closely on economic data before deciding when to raise short-term interest rates. This "data-dependency" does not change our belief that rates will be moving higher, the only question is when they will start rising. Current forecasts range from June 2015 through June 2016 as the start of the rate hikes, but this can change quickly based on a myriad of economic data. Barring any unexpected spikes in inflationary pressures, we believe that rates will rise in a slow and gradual manner over the next several years. At Tandem, we have been focusing on very short-dated bond issues maturing in five years or less.

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Our concern about longer dated bonds is the short-term principal losses that could occur when interest rates rise. Lending the US government money for 10 years at 1.8% nearly guarantees an inflation-adjusted loss when the Federal Reserve has publicly stated its long-term inflation goal is 2.0%.

We challenge market pundits who are discouraging investors from investing in bonds with our belief that modestly rising rates should in fact be welcomed by long-term investors, particularly in an era of generationally low yields. From current interest rate levels, interest income will be the primary driver of bond returns, and the ability to reinvest income into a gradually rising rate environment can increase total returns. So, for long-term investors, a modest rise in interest rates is actually preferred to flat or falling interest rates. In an atmosphere of slowly rising interest rates, investors can generate higher long-term returns, rather than lower.

In conclusion, Tandem believes bonds serve a valuable purpose for investors. Bonds provide relative stability and income, especially when equities become more volatile and unpredictable.

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