

Planning & Investment News

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BOND BUBBLE

Talk of a possible “bond bubble” is fairly widespread. The term “bubble” usually refers to a situation where an asset class is selling for much more than the “intrinsic value” (think home prices around 2005-2006.) With interest rates at historic lows, it is hard to see much additional upside potential in owning bonds (outside of the scheduled interest payments).¹

Currently, bonds (via mutual funds) constitute a larger portion of our portfolios than ever before. Since bonds are in essence a promise to pay from the issuer (either a corporation or government entity), they are considered less risky than equities (stocks) which represent a percentage ownership in a corporation. If a corporation does well, stockholders are usually well rewarded. If a company falters, it is the bondholders who are some of the first to be paid.

Since most investors do not have a need for funds in the short term, we have previously used more equities in portfolios as the potential return was considered worth the risk. Given the uncertain nature of today’s global economy, we are less inclined to overweight equities.

For several reasons, we do not think we are in the middle of a “bond bubble”. And as research by the Vanguard Group has shown, a completely unexpected interest rate shock would only result in a loss that would be expected to be recouped within three years.² Regardless, this is a matter we watch very closely. We have mitigated the risk in the portfolios by using primarily less risky shorter term bonds, by using more international (global) bonds, and by using funds that can attempt to mitigate risk by employing sophisticated currency trading.

Bond positions are a very important part of our current investment strategy. The reliability of a bond’s dividend is a large portion of the portfolios expected return in this challenging market. As stated in previous newsletters, we think this is not a time to be “reaching” for big returns. The wise thing, in our opinion, is plan for modest returns while remaining liquid for flexibility and thus why we like bonds. Whether this low return environment will last for one year, two years, or longer, we do not think anybody can know. We remain vigilant.



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Of course, as always, please do not hesitate to contact us if you would like to discuss your specific accounts.

On a personal note (I don't know about you, but I am getting tired of these "personal notes"), the cyst on my brain stem for which I had surgery back in July has reformed. The doctor is concerned of further growth and has recommended additional surgery. Therefore we have scheduled surgery for November 18th, but this time in Tyler as opposed to Phoenix. I expect to be out for two to four weeks. Again Bill and Sandy, along with Pat, will be holding down the fort (though hopefully I will be available from home). For those who are interested, my wife Karen has set up a blog at

www.caringbridge.org/visit/richardtruitt.

Thank you for your patience, prayers and concern during this ordeal.

Richard

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¹ The problem with bonds today is the low interest rates. When a corporation or government body issues a bond, it is usually with specifications that it will be repaid with a certain interest rate, over a set amount of time. So if a bond is issued with say a 5% interest rate, and rates rise to 6%, the value of that bond would decrease because who would want to own a 5% bond when 6% bonds are now being issued (all things being equal)?

The reverse is true if rates fall. In late 2008, when the credit markets were in disarray, interest rates increased. We over-weighted portfolios in bonds at the time, and as rates came back to "normal", those bonds increased in value handsomely. We felt, at the time, that this was "low hanging fruit" – an easy return.

² "And two years following the hypothetically worst bond market return ever [400-basis-point increase in interest rates], the diversified bond investor would be close to breaking even, simply by reinvesting interest distributions." *Risk of loss: Should investors shift from bonds because of the prospect of rising rates?* Christopher B. Philips, CFA, et al, Vanguard Research, page 3.