March 2013

Risk of Investing in Bonds

There has been an increase in noise in the media of a pending "bond bubble." While I feel that there is risk in the bond market, I don't feel that there is an immediate need to fear bonds. That said, there are risks of owning a high percentage of bonds in your portfolio.
Gone are the days when bonds will significantly outperform the stock market. As you can see from the chart below, having 40% exposure to your portfolio in 2011 helped your portfolio's return. In 2012, and so far year-to-date in 2013, bonds have actually hurt your portfolio's return.

	2011	2012	YTD 2013
S&P 500	-0.01%	13.41%	9.58%
Barclays Aggregate Bond Index	7.84%	4.22%	-0.09%
60/40 Balanced Sample Portfolio	3.13%	9.73%	5.71%

(The S&P 500 is a stock index made up of 500 large and mid-sized companies. The Barclays Aggregate Bond Index is comprised of approximately 1/3 U.S. Treasury Bonds, 1/3 U.S. Government Agency Bonds, and 1/3 Corporate Bonds. The 60/40 Balanced Sample Portfolio is 60% S&P 500 stocks and 40% Barclays Aggregate Bond Index. The returns of the 60/40 Balanced Sample Portfolio are not actual portfolio returns but rather a weighting of 60% of the S&P 500's return and 40% of the Barclays Aggregate Bond Index return for each respective year. 2013 YTD is as of 3/27/13. We are not recommending this allocation, but rather using it as an example of the effect each index has on returns. Past performance is not a guide to or indicative of future results.)

The Federal Reserve ("the Fed") has taken an extended low (or no) interest rate stance in an attempt to help our economy. The Federal Reserve has stated that it will keep interest rates low until unemployment is at an acceptable level, but these efforts cannot go on forever. In the short-term, meaning over the next twelve to eighteen months, the likelihood of the rates going up is quite small. In the most recent minutes released by the Fed, only one Fed member wants to raise rates in 2013 and four want to raise rates in 2014 (out of 12 members).

When rates rise, bond prices will fall. The longer the duration, the worse the price will move down. Just a 1% rise in Fed Funds rates can have an impact, as shown below.

	Current			1% Rise over 1 Year			
	Yield	Price		Price	Income	Total	%Return
2-Year Treasury	0.46%	$1,000.00		$980.43	$4.60	$985.03	-1.96%
5-Year Treasury	0.79%	$1,000.00		$952.57	$7.90	$960.47	-4.74%
10-Year Treasury	1.91%	$1,000.00		$914.31	$19.10	$933.41	-8.57%
25-Year Treasury	2.88%	$1,000.00		$841.78	$28.80	$870.58	-15.82%

(These calculations are accurate as of 3/27/13 and are being used as an example of how a 1% rise of interest rates would affect bond prices with different maturities. These calculations are thought to be accurate but cannot be guaranteed.)

Keep in mind that the current Fed Funds Target is held at 0% to 0.25%. The Average Fed Funds Target from 1990 to present is 4.27%. When rates do rise, there will be a significant impact, especially with long-term bonds. If we were to see rates move from where they are today to 4.25% (the average over the past two decades), a 30-Year Treasury would lose almost half of its principal value.

What Is Polaris Going To Do To Combat This Risk?

We will…

- Keep the duration of your bonds short, under five years.
- Invest in higher coupon paying bonds which should offset downward price movements more effectively.
- Invest in other types of income producing investments, such as: preferred stock, convertible bonds, MLPs, etc.
- Consider alternative investments to protect against downward bond price movements.
- Lower your percentage exposure to the bond market.

We are dealing with unprecedented times in portfolio management which will require thinking outside of the traditional box of managing money. Polaris has had a history of mitigating risk within our clients' portfolios, and we will continue in our endeavor to protect our clients from real risks in the market.

As always, I welcome your questions and comments. Please feel free to reach out to me via e-mail, phone, or scheduled meeting.

Sincerely,
Jeff