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Bonds Can Be Beautiful

The investment environment so far in 2009 has been pretty choppy, to put it mildly. We saw the collapse of a stock market rally that began back in November and now we're into another bear market rally that began in March. This rally, too, looks a little shaky and I personally suspect it will collapse the way the last one did.

For this reason, I have not jumped onto this latest rally with my clients' capital. The code that guides physicians begins by saying that the first obligation of a doctor is to do no harm. I think this applies equally to financial advisors, so my going in predisposition is to be cautious. When capital is lost, it is gone for good. The only way to recover is to inject fresh capital from other savings into the account, which does work quite well, or to recover through successful investment of the remaining balance, which can take a bit of time.

The math on this is quite clear. It takes a much larger percentage gain on a smaller base to recover from a given percentage loss on the original balance. To illustrate, it takes a 100% gain to recover from a 50% loss. Thus capital preservation drives my strategy of risking capital very cautiously and then taking small losses early and letting small gains run. This avoids large losses, which can cripple a portfolio, but still allows for the possibility of large gains, which can make the whole strategy a great success.

So what is our strategy? We have nibbled a bit around the edges in the stock market, seeking companies with brighter prospects in this recessionary environment and that effort has been not terribly productive as yet. On the other hand, we've found a lot of value in high quality fixed income securities, both in municipal and corporate bonds and we have been increasing our allocations in this area. Many folks developed an aversion to bonds back in the 90's because when compared with the very outsized returns on stocks in that era, bonds were pretty boring. In this decade, however, when most of the excitement in stocks has been on the downside, boring looks pretty good.

Along the way, I have developed two independent sources for bonds outside of T.D. Ameritrade. These two bond specialty shops, in competition with T.D. Ameritrade, allow me to get very competitive prices on bonds for my clients. These brokers know what kind of bonds I am looking for and do a great job of bringing potentially attractive opportunities to my attention.

For taxable accounts of clients in high tax brackets, we've been focused on some very attractive opportunities in tax-free municipal bonds. Today these bonds, which are very low risk investments, are paying yields higher than comparable Treasury bonds, which are taxable. This is a rare situation, caused by the rush into Treasuries by folks bailing out of the stock market. So, we are looking to take advantage of this situation for our clients where tax exempt income makes sense.

For IRAs, where the assets are tax deferred, we have been using some high quality corporate bonds, which today are paying attractive yields, and a somewhat rarer breed of bonds, taxable municipal bonds. Yes, some municipal bonds are issued which are not tax exempt. These then pay higher coupons than their tax exempt brethren and make good choices inside IRAs.

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*“If you wish to
succeed in life,
make
perseverance
your bosom
friend...”*



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*“...experience
your wise
counselor,
caution your
elder brother,
and hope your
guardian
genius.”*

Joseph Addison
(1672 - 1719)

By laddering the maturities inside an account, we are able to generate solid, if not spectacular, returns while maintaining the flexibility to reallocate capital into the stock market when the risk/ reward conditions improve, which I am sure they will at some point in the future. In addition to income, we can actually generate capital gains with bonds, including the purest form of compounded gain using zero coupon bonds. I'll avoid going into the details on how this works for now, but if anyone really wants to know, I'll be happy to explain it to them at their convenience.

Now, to wrap up this discourse on bond investing, I must point out that I usually plan to hold a bond to maturity when I buy it for a client. On the other hand, asset custodians, including T.D. Ameritrade, provide a market valuation for bonds in your account statements as if you were trading them every day. These valuations, however, are more like real estate appraisals than the actual values you see on your stocks and mutual funds. That's because bonds, with a few exceptions, don't trade all day on an auction market the way stocks do. So there are several specialty companies who provide asset custodians with their best guess on the value of most bonds, based on what similar bonds have traded for recently, the same way a real estate appraiser provides an appraisal on your home based on what homes similar to yours in your area have sold for recently. These guesses change just about every few days, based in large measure on changes in interest rates, so they do affect the total value of your account shown in your statements.

One quality unique to bonds, however, is that we do know precisely what they are worth on one date in the future, their date of maturity. So if we hold bonds to maturity, the ever-changing valuations shown for bonds in your statements are basically irrelevant and I encourage you to place very little weight on them in reviewing your statements.

Investment environments like the one we're in now require lots of patience. The challenges in the credit markets and the real estate markets will take a while to get corrected and until they do, I believe we'll see a number of sharp stock market rallies which will usually fade in weak trading volume. If you're a nimble day trader, you might be able to capitalize on these, but the risk to reward case for this is not very attractive.

When this market does begin a sustainable upward trend, they won't sound a bell, so we don't expect to catch the exact bottom. (Lots of impatient folks will lose a lot of money trying to do so). When the sustainable rally reveals itself, we'll be able to make the adjustments to take on enough additional risk exposure to benefit just fine.

Warm Regards

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