



## **Surprising Choices in the Search for Safety Near-Certain Loss of Purchasing Power versus Short-Term Volatility?**

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Risk, in its many guises, is unavoidable, and investors today are taking on significant amounts of credit risk, duration, and leverage to obtain high yields from many presumably safe bonds. But certain types of risk are often mispriced. By overweighting one's portfolio to those sectors that currently offer attractive risk-adjusted returns, investors will be better positioned to meet their long-term goals.

Since the stock market bottomed in March of 2009, through the end of this past August, bond mutual funds have experienced net inflows of about \$900 billion, while stock mutual funds saw net outflows of almost \$200 billion. During the same period, the S&P 500 returned 123.8% (including reinvested dividends), while a 10-year U.S. Treasury bond purchased at the very bottom of the market, on March 9, 2009, earned a relatively meager 22.5%, even as interest rates fell to generational lows.

This seemingly poor asset-allocation decision on the part of many investors should come as no surprise – investors have shown an uncanny propensity over many decades for buying high and selling low. Given that yields would have to turn negative for a 10-year Treasury bond purchased today to replicate its performance of the last few years going forward, it is difficult to explain why this trend toward bonds has accelerated over the past 12 months.

The most common explanation is that investors are more risk averse than ever after having lived through the financial crisis, the flash crash, and the continuing bombardment of bad news coming from the eurozone. While likely an accurate explanation for investor's behavior, it's completely inadequate as a justification, because it ignores two crucial facts: all investors, even those in cash, are taking risk in some form, and all investors need to earn a high enough return on their assets to allow them to meet their goals. Buying a 10-year US Treasury at a 1.70% yield clearly won't provide sufficient return for the vast majority of investors, so investors should be asking themselves, "Which type of risk am I comfortable taking in order to meet my goals?"

Unfortunately, many investors today think they can avoid this question simply by investing in bonds or bond funds that appear to offer marginally higher yields than do traditional,



high-quality fixed income investments. Bonds being bonds, investors assume these investments offer them the safety they want, plus a little extra yield as a bonus.

Many investors have opted to take on credit risk in the form of high-yield bonds, preferred stocks, or emerging market debt in order to increase yield. Inflows into these sectors have accelerated in recent months, despite the ever-tightening incremental spread an investor gains by taking on additional credit risk.

Investors need to remind themselves that the quoted yield on a high-yield bond is *before* any adjustment for the probability of default. Once default is factored in, the incremental yield will not amount to nearly as much as many investors believe, and in certain cases it will result in a lower yield than could have been obtained with higher-quality bonds. Venturing into these credit-sensitive sectors of the bond market also abandons one of the core functions of fixed income within a portfolio, which is to provide stability during times of distress. Investors may recall that these sectors were more correlated to equities than were high-quality fixed income during the market downturn that struck in 2008.

Other investors have reached for extra yield by extending the duration of their portfolios. An investor who is willing to go out 20 years might be able to earn 3.5% on a high-quality corporate bond or 3.0% on a high-quality municipal bond. While those returns might seem attractive relative to short-term bonds yielding less than 1%, the prices of these bonds are very sensitive to changes in interest rates. For example, if interest rates rose 2%, the hypothetical 20-year corporate bond yielding 3.5% would suffer a decrease in market value of 23%. Because an individual bond can be held to maturity, an investor won't be forced to recognize this loss, but the loss will manifest in lost purchasing power for the investor if interest rates and inflation rise in tandem, as they usually do.

Investors in bond funds get further penalized, because the option of holding to maturity doesn't exist. Once rates start to rise, many bond fund investors will sell when they start to see declines of 10% or greater in what they thought was a "safe" investment, which puts further downward pressure on prices. And many such investors end up with a capital gains tax bill when fund managers sell off bonds that had previously appreciated.

Currently, investors are – perhaps unwittingly – embracing leverage in their fixed income investments, either through direct borrowing or through the many funds that hold derivatives. The leverage is designed to enhance fixed income products' yield, but it can also increase risk during times of distress. Many of us remember the two Bear Stearns mortgage hedge funds whose collapse made headlines in 2007: After several years of posting attractive and consistent returns by buying long-duration mortgage-backed securities financed with short-term debt, they proceeded to lose more than 90% of their value when the value of the mortgage-backed securities fell, forcing the funds to sell at an inopportune time in order to cover their margin calls. In addition to some hedge funds that are once again playing that game, other examples of levered fixed income investments include some closed-end funds and mortgage REITS. When rates do start to rise, these



investments will suffer, getting hit simultaneously by a decline in the value of their assets and a rise in their borrowing costs.

Are investors unaware of the possible – and most likely permanent – ramifications of the risks they are taking? Or do they simply think they will be able to sneak out of the party before the music stops?

### **Where risk is mispriced**

What is an investor to do when faced with either accepting an inadequate return with low risk or accepting a potentially alarming amount of risk in order to eke out a marginally higher return? Neither alternative is acceptable. Opportunity lies in choosing risks, such as volatility and illiquidity, that many investors shun, even though there's little danger that these risks will lead to a permanent loss of capital in the long term.

Too often, bond investors embrace the view that, because bonds are less volatile than stocks, they are automatically less risky. The problem with this definition of risk is that the biggest risk most investors face is outliving their money. With real, after-tax returns on most bonds now less than zero, investors should be asking themselves whether the near-certain risk of losing purchasing power is preferable to accepting increased short-term volatility by overweighting their portfolio with stocks in exchange for the likelihood of much higher returns.

Investors can get a higher dividend yield from owning an S&P 500 index fund than they can from a 10-year Treasury. Furthermore, unlike the interest payments on a 10-year Treasury, the dividends on the S&P 500 can grow, which is likely to be the case, because S&P 500 companies are only paying out 28% of their earnings in the form of dividends, compared with the long-run average payout of more than 50%.

For a more specific example, Johnson & Johnson (JNJ), one of the few AAA-rated companies with bonds outstanding, has a bond maturing in 2020 that is trading at a yield of 1.8%, but the stock has a current dividend yield of about 3.5%. To be worse off holding the stock instead of holding the bond until it matures, the dividend would have to never grow (despite JNJ's dividend growth averaging 8.5% annually over the past five years) and the share price would have to be 16% lower in 2020 than it is today (despite the stock already trading at 13-times earnings, a relatively low multiple). Owning the stock will be a bumpier ride, but a relatively dire set of events would have to transpire for the stock to underperform the bond over the next eight years.

As with volatility, liquidity matters to individual investors, yet it is generally not necessary or important for an investor to liquidate most of his or her portfolio at any given moment. This is especially true in IRAs or other tax-deferred accounts, from which most investors won't need to take withdrawals for years. And when investors do make withdrawals, they likely



will require only small amounts of liquidity annually (perhaps 5%–10%, to comply with the required minimum distribution rules).

Investors prefer liquidity, and that creates opportunities, such as those in the market for non-agency mortgage-backed securities – specifically the senior tranches that were formerly rated AAA. Despite a significant rally in prices throughout 2012, typical seasoned pass-through securities originally issued from 2003 to 2007 still trade at *loss-adjusted* yields between 4.0% and 6.0% with an average life of 5–7 years. Downside risk is relatively low. For these investments to lose money would require the unlikely scenario of the U.S. housing market experiencing *another* severe decline.

Furthermore, these mortgage-backed securities will benefit, or at least hold up well, in a rising interest rate environment. Many of these bonds are backed by adjustable-rate mortgages, so the coupon payments will rise with interest rates, while the generally higher-quality collateral backing these bonds should be able to digest a higher loan payment without a significant increase in default risk on the underlying loans.

Investors have continued to eschew these securities (which are still considered somewhat of a dark corner of the fixed income market) and their relatively high yields because of the difficulties involved in analyzing and trading them. In other words, investors avoid them because they are illiquid. Even this concern is misplaced, however, because these bonds generally pay out between 10% and 15% of their market value annually in the form of interest and principal payments, which is more than sufficient to satisfy an investor's liquidity needs, even if he or she never actually sells any positions.

Risk is unavoidable. Earning an adequate return requires bond investors to choose which risk best allows them to meet their goals: credit risk, duration, leverage, volatility, or illiquidity. Regardless of which you choose, there is no such thing as a riskless investment. The best any of us can do is to choose a higher exposure to those risks that are currently underpriced. An investor who adopts that approach maximizes his or her chance to obtain satisfactory risk-adjusted returns.

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