Is the Glass Half Full or Half Empty?

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Financial Market Response

Just as the stock market witnessed unprecedented gains in the late 1990's when the S&P 500 strung together five consecutive calendar years of 20% + gains (a feat never before accomplished!), the pain experienced over the past two and one-half years has been equally striking. Through September 30, 2002, the S&P 500 had suffered roughly a 47% decline since its peak 929 days prior, longer in duration than the infamous 1973–1974 bear market, but nearly identical in terms of severity. The third quarter ending September 30 was the S&P 500's worst quarterly performance in 15 years and 2002 is on course to be the third consecutive year of losses for the first time in 60 years. The performance of the general stock market has been disappointing to say the least—it has also been a reflection of an overheated and speculative market in the late 1990's (remember those dot coms?), as well as a reflection of a deceleration in economic growth.

But all has not been lost by investors with well-diversified portfolios. Two areas in the U.S. stock market that have performed relatively well over the preceding 30 months ending September 30 are value-oriented stocks of smaller companies (up about 14% during this time frame) and mid-cap value-oriented stocks (up about 2%). Real estate investment trusts (REITs) have performed even better, supported by attractive dividend yields, rising a remarkable 45% over the prior 30 months. Bonds have performed well too, helped by a declining interest rate environment (see related story, ***Bonds at Risk?***). Over the past 2-1/2 years, U.S. bonds have generated annualized total returns of about 9% on average.

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Bonds at Risk?

Many investors see bonds as an investment with little risk—you receive coupon payments at regular intervals and, once a bond matures, you receive your initial investment back (the bond's par value). However, investing in bond mutual funds does involve risk, including default risk and interest rate risk, though many believe, incorrectly, that you cannot lose money.

Aside from default risk, or the chance that the issuer of the bond will be unable to pay the par value at maturity (usually due to bankruptcy), you also are subject to interest rate risk. Interest rate risk is the effect that interest rate movements have on the price of bonds. Bond prices move inversely to interest rates; that is, as interest rates decline (as they have for several years), bonds appreciate (their prices go up). Given that interest rates are at 40-year lows, the likelihood has increased that interest rates are more likely to move significantly up from current levels rather than continue their decline. Consequently, bond prices are at risk of falling and, depending on how much interest rates were to increase, could lead to a negative return (remember that even if bond prices were to fall, the bonds would still generate income from their coupon payments). To place this in perspective, if interest rates were to increase by more than 1%, a negative total return could result for the typical bond over a one-year period.

To mitigate the interest rate risk inherent in bond investing, we structure client portfolios without long-term bond funds because such funds are highly volatile and respond poorly to rising interest rates. Instead, our focus is on short- and intermediate-term bond funds, which are less likely to generate a negative return. In addition, we normally allocate a small percentage of a client's fixed income exposure to a high-yield bond fund, which invests in what are commonly known as "junk" bonds. Such funds tend to perform well with a strengthening economy and an improving stock market. They are also less susceptible to interest rate risk due to the higher proportion of their total return that is generated from the underlying bonds' coupon payments. (See our ***Portfolio Manager Insight: Janus High-Yield Bond Fund*** article for an analysis of our favorite high-yield bond fund.)