The COMPASS Chronicle

May 2013 | Vol. 3 No. 5 | "Morningstar's Best Client Newsletter" in 2012

A Bond Bubble?

By Louis E. Conrad II, CFA

- Bond investors have been the beneficiaries of a 30-year plus bull market (though with some corrections along the way) as interest rates have declined.
- COMPASS expects interest rates to reverse course as the economy improves and the Federal Reserve ultimately halts its bond buying program.
- This reversal in interest rates could spell disaster for conservative investors who have not structured their bond holdings appropriately.

Bond investors have enjoyed more than 30 years of generally declining interest rates. As yields have fallen, bonds have appreciated, leading to a long bull market for bonds. Since the 10-year U.S. Treasury peaked at a yield of 15.8% in 1981, yields fell to a record low of 1.38% in July, 2012 (they were less than 1.7% recently). Given the historically low yields that bonds are presently trading at, some market commentators believe bonds could be subject to a meaningful decline in value. They fear the bursting of a bond “bubble” and argue that bonds should be sold prior to a reversal in interest rates.

Bond Basics

The most basic concept to understand with regard to bonds is that their prices move inversely to interest rates. That is, as interest rates decline, like they have for over 30 years, the value of bonds will increase. Conversely, should interest rates rise, bond prices will fall.

The impact of higher interest rates on the bond market could be meaningful, especially if they were to increase significantly over a short period of time. In such an environment, the value of bonds could unravel, leading to significant losses. For the U.S. bond market overall, a 1% increase in interest rates could mean a 5% decline in bond prices.

It is important to remember that a bond’s return has two components: (1) a change in the bond’s underlying value, just like a stock, which is usually due to interest rate changes or credit quality changes and (2) interest income. A changing interest rate environment will impact a bond’s price, but not the interest income generated by an existing bond (except floating rate notes, which are referenced below).

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More about COMPASS Wealth Management, LLC

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A Bond Bubble? continued

Quantitative Easing

As a result of the Financial Crisis, the Federal Reserve has instituted monetary programs (commonly referred to as Quantitative Easing, or QE) that have involved the purchase of U.S. Treasury and mortgage-backed securities. The goal has been to prop up bond prices, and thereby lower interest rates, so that the economy and housing market could mend. In that regard, many believe the Fed's policy has been successful as witnessed by the decline in interest rates. The U.S. economy, though hardly booming, has generated growth since the Financial Crisis, whereas the European Union is now back in a recession. Our housing market is also finally healing as evidenced by declining inventories and increasing prices.

While the Fed's QE program has had positive effects on the U.S. economy, it has also led to a tripling of the Fed's balance sheet since the onset of the Financial Crisis. The Fed's bond buying program will need to be curtailed and ultimately reversed. Just as the Fed's bond purchases stimulated economic growth, their curtailment will have the opposite effect. In fact, without the Fed's QE program, many market prognosticators believe the yield on the 10-year U.S. Treasury would be 0.50% - 1.50% higher than the current rate. As the bond purchase program is curtailed, which is expected to occur between late 2013 and 2015, interest rates are expected to rise to more normal, less Fed-induced levels.

Actions to Consider

COMPASS Wealth Management, LLC believes that this is not an all-or-nothing choice. We advocate for allocating some portion of each client's portfolio to bonds, depending on their investment time horizon, risk tolerance, and other factors as a diversification measure irrespective of the market environment. Though we advocate maintaining a bond allocation, we are also mindful of the deleterious effects that rising interest rates can have on bond holdings. Consequently, we suggest the following:

* Avoid long-term bonds as these are most susceptible to harsher price declines in a rising interest rate environment. Favor short- and intermediate-term bonds instead, whose market value will hold up better when rates are rising.

* Diversify into other areas of the bond market, depending on your appetite for risk and market opportunities, such as floating rate notes, high yield bonds, and international debt, including the emerging markets.

Depending on your income tax bracket and the types of investment accounts you have, you may want to consider corporate or municipal bonds, but this is a topic for another time. Whatever types of bonds you invest in, be sure to be cognizant of the impact interest rate changes can have on the value of your bonds and position them according to your individual circumstances and the interest rate environment.