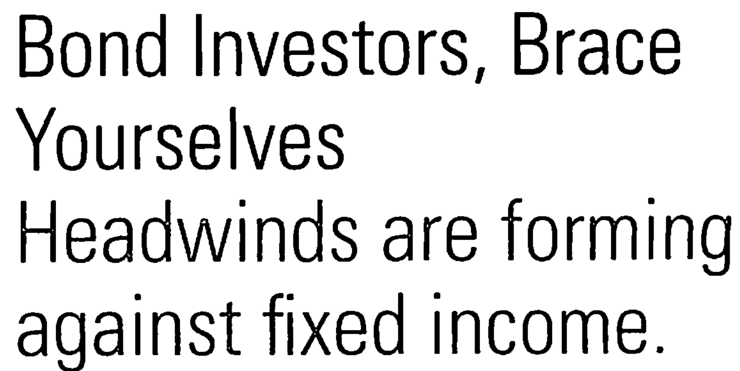

Bond Investors, Brace Yourselves

Headwinds are forming against fixed income.

In this section:

30 **The Game Is Up** — Miriam Sjoblom

34 **Some People Are Bullish on Bonds** — Sonya Morris

37 **Bonds We Like** — Haywood Kelly

The Game Is Up

By Miriam Sjoblom

The bargains are gone, yields are low, and rates are bound to rise. Discouraged? You should be.

"The game is rigged, but you cannot lose if you do not play."
—Marla Daniels, "The Wire"

In the HBO drama "The Wire," Marla Daniels was talking about city politics, but her advice could be applied to today's fixed-income markets. Bond investors, take heed: The game looks rigged.

Owners of bonds get their returns from two places: income and price appreciation (or depreciation). In light of the low level of current yields across bond sectors and the threat of higher rates to come, neither factor gives investors cause for optimism.

Now that 2009's record-breaking bargains are gone, bond fund managers' jobs have gotten a lot tougher. The same risks that roiled markets in the past decade won't necessarily dominate in the one ahead, and it's more important than ever to understand the compromises and trade-offs bond managers now must make. Otherwise, in this game, you and your clients won't have a sporting chance.

An Income Shortage

Let's start with income. After 2009's rebound among nongovernment bonds, yields across bond sectors now hover near their all-time lows. The 3.5% yield on the Barclays Capital Aggregate Bond Index, a common benchmark for many domestic investment-grade bond funds, is as low as it's been in its nearly four-decade history. To put that into context, the index yielded anywhere from 7% to 10% for much of the 1970s. It then climbed as high as 15% in 1981 but dropped below 9% by the end of that decade. During the 1990s, it fluctuated between 5% and 9%.

So, from an income standpoint, bond investors are hobbled. Even if yields stay where they are for the time being and investors in index-hugging taxable-bond funds are able to collect their 3.5% return from clipping bond coupons, that's still a far cry from the 6% annualized return delivered by Vanguard Total Bond Market Index VBMFX during the past decade, or its 7.5% annualized gain in the 1990s. Actively managed bond funds with high-quality mandates aren't in much better shape. After 2009's rebound, the additional yield offered by some bond sectors has narrowed considerably. For example, the average yield spread on investment-grade corporate bonds has narrowed to less than 150 basis points today from 600 basis points in late 2008. (The highest-quality corporates now offer a slim 50 basis points over Treasuries.) As a result, the average absolute yield on investment-grade corporates has dropped below 4.5%.

Many managers have often relied on agency mortgage-backed securities—those issued by Fannie Mae, Freddie Mac, or Ginnie Mae—for extra income, but they're finding that to be more difficult today. The Federal Reserve's gradual purchase of $1.25 trillion in agency mortgages (it finished buying in March) has driven prices up and yields down to the point where many managers argue they've rarely looked more expensive. Government programs such as the Term Asset-Backed Loan Facility and the Public-Private Investment Partnership have had their intended effect of restoring liquidity to the nongovernment securitized bond market, but they've also raised valuations in the asset-backed and commercial mortgage-backed securities sectors. Meanwhile, the private securitization of commercial and residential mortgages has not revived, and that lack of supply is another factor pushing yields lower.

A Threat on the Horizon

If a paltry income stream isn't enough to get you rattled, perhaps the threat of higher yields will. That's not to say a huge spike in interest rates is imminent. The broad market consensus expects the Federal Reserve to keep its target short-term rate near zero for several more months, if not through the rest of 2010. Ben Bernanke's Fed has also gone to considerable lengths to remove the element of surprise from its playbook, and it's consid-

ered gospel that the Fed will alter its "exceptionally low for an extended period" language well in advance of any actual tightening. There's some uncertainty about how the market might react to that signal alone, of course. As PIMCO's cash guru, Paul McCulley, stated earlier this year, "The most important book at the Fed right now is a thesaurus."

Shorter borrowing rates often move in lock step with the Fed's moves, but longer-term Treasury yields can have minds of their own. The market's confidence in the Fed's ability to keep inflation under wraps matters a lot. Many observers agree that still-large output gaps and high unemployment should keep inflation muted in the near term. The Fed also has many more tools at its disposal today to combat inflation—including hiking its target rate, draining bank reserves, and selling bonds—than it has to fight deflation, and investors know it.

Simple supply-and-demand dynamics also play a role, and on that front, the case for lower-for-longer Treasury yields weakens. Although the final amount depends on the speed and magnitude of an economic recovery, many analysts predict that the Treasury will have to issue more than $2 trillion in debt by the end of 2010 ($1.9 trillion was issued in 2009). The Treasury has also announced its intention to shift new issuance away from short-term T-bills into longer-term notes and bonds, which could apply upward pressure on longer maturity yields. Regardless of the economy's near-term fortunes, the mounting entitlements of Medicare and Social Security, coupled with an aging U.S. population, argue loudest for more Treasury issuance and higher yields in coming years.

However yields behave in coming months, they have less room to fall and more room to rise. What makes the threat of rising yields so combustible today is the lack of income available to offset price declines. If you take the yields on the various Barclays Capital indexes that track different bond sectors and divide those by the indexes' duration, you get a rough estimate of how high yields would have to rise before price declines would wipe out offsetting income. The answer for investment-grade bond sectors is around 50 to 100 basis points (see table). Investors who have moved into short-term bond funds believing that these funds' low durations will protect them from rising rates could also be in for a shock. Short-term yields are so minuscule that there's very little income to cushion the blow when the Fed eventually starts tightening, making losses a real possibility.

Staying in the Game

If bond investors understand just how rigged the game is, they may approach their bond allocations with a bit more trepidation. But judging by the billions that have continued to flow into bond funds so far in 2010, it seems that investors don't appreciate that fixed income faces an uphill battle in coming years. Those who are chasing bond returns of the past decade should note that bonds no longer enjoy the income advantage or the tailwind of declining rates that propelled them over that period. Cash investors who've become impatient with near-zero money market yields may also be turning a blind eye to the risks they're taking on for very little reward.

Bonds still have a place in long-term asset allocations, however. Many factors come in to play when deciding whether to buy individual bonds or bond funds, but in a rising-rate environment, owning bond funds may have some advantages. When market rates rise, bond-fund yields adjust upward with a lag, as managers put the portfolio's coupon payments to work at higher prevailing yields and trade out of less-price-sensitive shorter maturities into higher-yielding alternatives. Investors who buy individual bonds today are locking in yields near all-time lows. The peace of mind they get from not having to watch their funds' net asset value decline is an illusion that masks the opportunity cost they're paying for the privilege of tying money up in lower-yielding securities.

Low All Around: Yield/duration estimates how far yields would have to rise for price declines to wipe out returns from income.

	Yield %	Duration	Yield/ Duration
Barclays US Aggregate	**3.4**	**4.7**	**0.71**
US Agg 1–3 Year	1.4	1.9	0.76
US Agg 10+ Years	5.1	11.7	0.44
US Treasury	2.3	5.2	0.44
US Treasury 1–3 Years	1.0	2.0	0.49
US Treasury 10–20 Years	4.1	10.0	0.41
US Corporate	4.3	6.5	0.66
CMBS	5.2	4.0	1.29
ABS	2.4	3.3	0.73
US MBS	4.0	3.7	1.07
Barclays US Corp High Yield Idx	**8.1**	**4.3**	**1.89**
US Corp High Yield BB	6.9	5.0	1.38
US Corp High Yield B	7.7	3.9	1.97
Barclays Emerging Markets	**6.0**	**6.5**	**0.92**
Barclays G-6	1.8	7.0	0.25

Data as of April 30, 2010.

While no bond manager possesses a panacea for rising rates, the typical manager has many tools to protect his or her portfolios. Not all managers agree on the best way to prepare for a rising interest-rate environment today, though, so it's critical to take a closer look at how they're positioning their funds to fully understand the scenarios under which your investment will thrive or falter. Out of the diversified bond managers we survey, it appears that many are currently playing variations on one of two themes: The Gross or The Fuss.

The Gross

Some managers view the economy's recovery as tentative, and they're paring back exposure to the credit-sensitive bond sectors that have rallied over the past year. As a result, those with a narrowly focused mandate may hold sizable exposures to bonds backed by the U.S. government. While these sectors come with minimal credit risk, they can be highly sensitive to rising rates. Mortgages in

particular are susceptible to extension risk, or the risk that investors will refinance their mortgages at a slower pace than anticipated, sticking bondholders with lower interest payments for longer.

PIMCO's Bill Gross falls into this uncertainty camp. He's recently cut back exposure to areas that have rallied in his flagship fund, PIMCO Total Return Bond PTTRX, particularly investment-grade corporate bonds and agency mortgages. But instead of turning to Treasuries, he's taking interest-rate risk in areas his team thinks are less likely to feel the same upward pressure on yields, including in countries such as Germany, Canada, and Brazil. As of March 31, his fund staked as much as 18% of assets in developed-markets debt outside the United States. Many other high-quality managers don't have the same flexibility.

The Fuss

Other managers are more confident that the economy is on the mend, and they view rising yields as the primary risk facing bond investors today. As a result, they're opting to take credit risk over interest-rate risk. This isn't as simple as "chasing yield." Improving corporate fundamentals, supported by a shrinking default rate and an uptick in rating agency upgrades versus downgrades, justify tighter yield spreads at this stage in the credit cycle. That's a key difference between today and the pre-crisis era of 2006-07, when underwriting standards were deteriorating, fundamentals got worse, and credit spreads were minuscule.

Lower-quality bond prices could also be resistant to rising Treasury yields. With an additional yield advantage of 400 to 600 basis points over Treasuries, these securities throw off more income to offset an identical rise in rates. In addition, junk-bond yields often don't move in sympathy with Treasuries, because rising Treasury yields are often the side effect of a stronger economy, a scenario that favors junk-bond yields. Leveraged loans can offer even more direct protection against rising rates. Their interest payments periodically adjust upward along with a short-term reference rate such as the London Interbank Offered Rate. And although they're also typically issued by companies with a lot of debt on their balance sheets, they enjoy a senior claim on company assets that takes precedence over bondholders.

Dan Fuss and his comanagers at Loomis Sayles Bond LSBRX are prominent examples of those managers using credit risk to fight interest-rate risk. In addition to bulking up their high-yield bond stake in recent months, they're also turning to areas that offer some potential for capital appreciation, including bonds issued in so-called commodity currencies—the Australian, Canadian, and New Zealand dollars—and convertible bonds. Unlike straight bonds, convertible bond prices are often driven by movements in the prices of their underlying common stocks.

Both of these approaches come with their own sets of risks. The former leaves investors exposed to a sudden rise in high-quality bond yields, while the latter could struggle if the economy takes a turn for the worse, or if mounting concerns about developed sovereign risk spark a flight to safety. It's unclear which approach will have the upper hand in the year ahead. No matter which path you take—The Gross, The Fuss, or some combination of the two—the better you understand how a bond fund is preparing for today's challenges, the less likely you are to get caught up in fighting the previous decade's battles. M

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