

THE FIXED INCOME DILEMMA

INTRODUCTION

While we are normally glad to have fixed income (bonds) as a way to diversify and protect portfolio value, the current jitters over the future of the economy effecting stocks have many investors fleeing to fixed income as a “safe haven” for their investments. With the fixed income market flooded, the return on bonds now historically low, and the inevitable notion that inflation must rise, this presents a potential bubble growing in the fixed income market and forces the question, “What is the smart route to take for this important part of your portfolio?”

OUR POSITION

The purpose of fixed income stands at maintaining portfolio value as one of many aspects of diversification. A rush into fixed income in pursuit of rate of yield through longer maturities or lower quality is, at a minimum, inefficient and, worst case, risky investing.

DISCUSSION

Defining Bonds

Bonds, or fixed income investments, are issued by a government or company promising to pay back borrowed money at a fixed rate of interest on a specified date. Much like an individual loan paid back to a bank with an interest rate over a set term, bonds are one of the ways institutions raise capital by borrowing from investors and paying back the bond over the set term.

The typical investor thinks of bonds as safe and predictable and government-issued Treasury Securities are considered to be among the safest. For this reason, fixed income is usually considered the first building block of a balanced portfolio as it has the lowest expected risk among asset classes. In fact, depending on your age and investment goals, fixed income may be all you need. Mercer Advisors includes fixed income in most of our clients' portfolios for its diversification and stabilization benefits.

However, much like a bank, an investor does have to assume certain risks of lending money to a government or company, and while traditionally these risks are generally low, there are several factors that must be considered when investing in bonds.

Risk Factors

Like any investment, bonds carry risks: yields, duration, interest rate change, creditworthiness of issuer, and tax exposure, as well as a greater risk that inflation will outstrip a bond's rate of return.

YIELDS

The first thing to understand about bonds is the inverted relationship between yields (returns) and price. If yields of bonds are high, prices are low. If yields are low, then prices are high. This relationship will be examined in more detail later in this report as we look at how the current flooding of money into fixed income is impacting the yield/price ratio.

Today, the typical investor thinks bonds are more liquid than stocks, meaning that, although both can easily be sold, there is a better chance that bonds will be in a “good” position when you want to sell. While this is often true, bonds can be volatile. If we reflect back on how much the interest rate has changed in the last 10 or 15 years — or even the last five years — the volatility of bonds becomes more evident.

DURATION

Duration in bonds is a measure of the sensitivity of the bond's price-to-interest rate movements. Duration is measured in years and broadly corresponds to the length of time before the bond is due to be repaid.

Investors consider fixed income to come in two duration categories: short- and long-term. Most investors recognize that short-term bonds are less volatile than long-term bonds, but that long-term bonds offer higher yields.

While long-term bonds do yield more than short-term bonds, the advantage is not enough to compensate for the increased risk of holding the bond with a longer duration. The volatility of a twenty-year Treasury Bond is almost five times the volatility of a one-year Treasury Bond and the return is not nearly commensurate. So while long-term bonds may appear to be a smart investment at first glance, the risk becomes so high over the longer duration that it is not worth the return. (See Figure 1.)

Figure 1.



QUALITY

When you purchase a bond, you are loaning money to an entity. The financial viability of the entity is vital to reducing the risk of default on the loan you provided them. If you decrease the quality of a bond investment, you approach the credit and market risk levels of an equity investment and undermine the stabilizing effect of bonds. In the past bonds were considered safe, responsible, and even patriotic. That thinking led to some unpleasant surprises in the 1980s when investors lost large amounts of money to bonds with a high risk of default known as “junk bonds.” Still, even today, the lure of easy, stable money often overrides many investors’ common sense on the quality of the issuer.

TAXES

Bonds have become more complex in their tax liability. There are new taxable and tax-exempt securities that differ dramatically from the bonds of a decade ago. With changing tax laws, wondering whether to use Alternative Minimum Tax bonds, and monitoring heavy bond redemptions, many fixed income investors are finding it difficult to keep pace. It requires increasing sophistication to manage these investments properly and to determine their proper place in your portfolio.

FOREIGN CURRENCY

Purchasing power parity is the principle that you do not get a better deal just because you buy it with a different currency. In the majority of cases, the purchase is balanced and created equal through a variety of risks including exchange rates. However, it is important to know that without sophisticated calculations when buying bonds in different currencies, you introduce the variability of fluctuating dollar to yen, euro, etc. without any expected return on this variation.

The risks of fixed income should not be ignored or treated with blind faith that bonds are always “safe.” Yet this seems to be the case with a large number of current investors as you will see when we examine what looks to be the creation of the growing fixed income bubble.

A Fixed Income Bubble?

Bubbles are created when an excessive amount of money is poured into a category of investments driving prices up far beyond their fundamental value. When the bubble collapses, the investors are stuck with the depressed value of the investment versus the considerably higher price they paid.

For example, during the Tech Bubble, technology stocks such as Cisco were selling at 100 times their earnings. When

the bubble burst, investors who bought in at the high price were left with stocks priced at a fraction of their original investment. To compare this to bonds, a 1% (or less) bond coupon will have a similar return as a technology stock selling at 100 times its earnings. Despite the lessons of the Tech Bubble, investors have flocked, and are still flocking, to bonds with these low payouts.

Emotionally, we are experiencing the flip side of what happened in 2000. Just as investors were too enthusiastic about the growth prospects in the economy during the Tech Bubble, many investors today are far too pessimistic and are fleeing the stock market and flooding the typically “safe haven” of bonds, potentially inflating bonds far beyond their actual value.

The Investment Company Institute reports that from January 2008 through June 2010, outflows from equity funds totaled \$232 billion while bond funds have seen a massive \$559 billion of inflows. Since the end of May, 2010 alone, investors have pulled an estimated net \$51 billion from stock funds and put nearly \$94 billion into bonds. This sudden shift of funds is a red flag that a bubble may be inflating. (See Table 1.)

THE FINANCIAL SERVICES INDUSTRY RESPONSE

The financial services industry seems to be more concerned with selling to investors’ appetite rather than marketing prudent products. Instead of pointing out the pending risks, they are giving investors what they want — healthy or not. The primary indication of this is reflected in the fact that in the past year 414 stock mutual funds have vanished while a growth of new fixed income funds has flourished. Further, the largest mutual funds in America were once around the star power of Peter Lynch, Fidelity, Magellan, and then the allure of indexing Vanguard S&P.

What is the largest fund now? Fixed Income giant PIMCO's "Total Return" fund.

VALIDATING A FIXED INCOME BUBBLE

Flooding a market does not necessarily mean there is a bubble.

Comparing fixed income yields over the past 20 years, as Figure 2. shows, we see that yields, especially short-term, are at all-time lows, which dictates that prices are at all-time highs.

To understand the depth of impact the yields-to-price relationship can have on a bond, the duration of the bond is key. The duration of the bond determines how much the bond is impacted by a rate change. Simply said, if you have a bond with a 10-year duration and the interest rate moves up 1.5%, the bond loses 15%. If you have a bond with a 5-year duration and the interest rate moves up 1.5%, the bond only loses 7.5% (rate change × duration = gain/loss).

Another alarming fact is shorter-term Treasury bonds are yielding even less. The interest rate on standard non-inflation-adjusted Treasury bonds due in four years has fallen to 1%, or 100 times its payout. A 100 times price-to-earnings for some technology stocks was the tipping point in the Tech Bubble a decade ago. Could it be the same for government bonds?

As with the Tech Bubble and the Housing Bubble, many investors are now holding investments whose value is far below the price they paid for them — dangerously lower.

Table 1.

Billions, USD	AUM	YTD								
		2010	2009	2008	2007	2006	2005	2004	2003	2002
ASSET CLASS										
Money Funds	2,730	(477)	(435)	698	606	210	82	(97)	(168)	(9)
Fixed Income	2,364	202	397	60	117	66	43	6	42	131
US Equity	2,995	5	(2)	(37)	19	50	64	135	121	42
Int'l/Global	1,449	52	75	(38)	170	168	135	93	37	11
Asset Allocation	548	(6)	(18)	(39)	31	22	43	56	43	19
MARKET CAP										
Large Cap	1,584	(22)	(38)	(23)	(15)	6	35	53	43	(2)
Multi Cap	698	1	1	(11)	25	22	(4)	27	29	8
Mid Cap	319	4	4	(17)	9	5	23	23	22	15
Small Cap	345	6	10	4	(12)	11	8	27	23	20
STYLE										
Core	1,632	8	9	0	(3)	21	16	82	71	40
Growth	808	(20)	(16)	(19)	13	(2)	15	3	22	(21)
Value	486	1	(16)	(27)	(2)	25	32	46	24	22

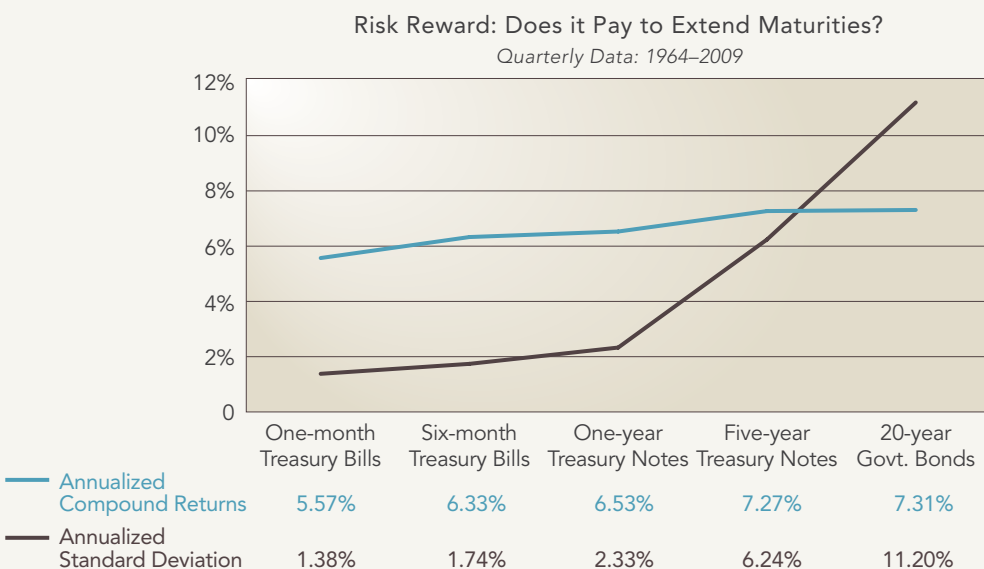
Source: Investment Company Institute, ICI

EXAMINING THE NEGATIVE POTENTIAL OF A FIXED INCOME BUBBLE

How big is the potential of the bubble? The "ultra-safe" Treasury Inflation-Protected Securities (TIPS) have a negative return! Treasury bonds are considered ultra-safe as the government "can't" go out of business, but even these bonds are now upside-down. So how do you lose money in the ultra-safe Treasury bonds? Here is how:

Yields on the five-year TIPS turned negative after the Federal Reserve said inflation is running below levels that reflect a healthy economy. TIPS pay interest on a principal amount that rises with consumer prices. As yields on conventional shorter maturities have plunged, investors have been willing to buy TIPS with negative yields betting that return from the inflation adjustment will exceed the interest the fixed-rate notes pay. This means that the purchasing power of this investment will fall, even if all coupons paid on the bond are reinvested.

Figure 2.



Source: Ibbotson, and Bank of America Merrill Lynch.

On top of this, investors must pay taxes at the highest marginal tax rate every year on the inflationary increase in the principal on TIPS—even though that increase is not received as cash and will not be paid until the bond reaches maturity.

This information alone suggests investors rushing into bonds and bond funds are courting disaster. The last time interest rates on Treasury Bonds were as low as they are today was in 1955. The subsequent 10-year annual return to bonds was 1.9%, or just slightly above inflation, and the 30-year annual return was 4.6% per year, less than the rate of inflation¹.

THE DANGER OF PREDICTING RATES WILL CHANGE FOR THE BETTER

Investing in a bond on the premise that rates are sure to turn around is a dangerous notion as a recent Wall Street Journal survey demonstrates. Looking at the predictions of 50 economic forecasters surveyed by the Wall Street Journal in June 2009, 43 expected the 10-year U.S. Treasury note yield to move higher over the year ahead, with an average estimate of 4.13%. Seven expected a rate of 5.00% or higher while only two predicted rates to fall below 3.00%.

The result? The 10-year Treasury yield slumped to 2.95% on June 30, 2010 and rates on 30-year mortgages fell to their lowest level since Fannie Mae began tracking them in 1971. How many of us would have expected this during a period when gold prices soared over 33% to a record high?

This is a strong message for investors predicting interest rates and bond prices. Predictions for interest rates and bonds are no easier than predicting stock prices. Decisions based on what appear to be certain outcomes at the time can often prove costly. Many investors who reconfigured their portfolios

in anticipation of higher interest rates have penalized their results while they are waiting.

THE BOND CREDIT RATING SYSTEM

When purchasing bonds, credit rating services provide ratings for bonds and the entities issuing the bonds. Some investors question the integrity of the rating agencies; however, Figure 3. shows recent ratings and their current default rates with Aaa being the highest quality rating and diminishing to the right. These default rates are in line with the ratings themselves showing the agencies are still maintaining integrity in their rating system. (See Figure 3.)

Conclusion: Vision vs. Circumstances

Whenever life events create challenges for us, we are forced to answer the questions: What do we really stand for? Will we let the circumstances sway our conviction, or will we stand on our principles?

While the stock market frightened less sophisticated investors into fleeing for the safe haven of fixed income, we have maintained the calmer, disciplined approach of utilizing only short-term and high-quality fixed income funds as only one aspect of diversifying our portfolios to maintain their value.

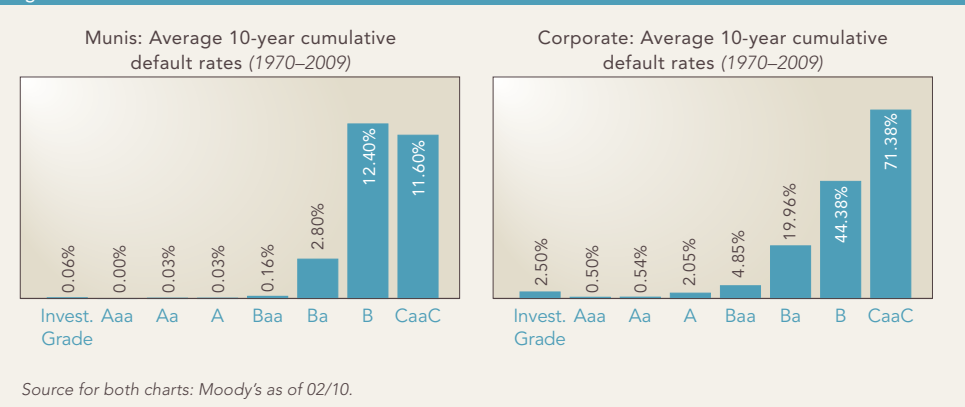
Regardless of investment trends of moving from one market to another, it is sticking to these sound, predetermined investment principles that maintains portfolio stability and reduces risk.

If the fixed income bubble bursts, we believe, maintaining our stand on a highly-diversified investment vision and not chasing bonds for higher returns (or following any other sudden flight to different markets) will prevail as it did through the Tech

Bubble, The Great Recession, and it will continue to serve us well.

The future of your investments is vital to funding your life goals. By standing by what we believe and holding true to our disciplined approach, we continue to safeguard your investments so you can feel confident in your portfolio and your goals for the future. ❖

Figure 3.



¹Siegel, Jeremy and Schwartz, Jeremy (August 18, 2010). "The Great American Bond Bubble". The Wall Street Journal. <http://online.wsj.com/article/SB10001424052748704407804575425384002846058.html>. Retrieved September 30, 2010

As always, past performance is not indicative of future returns. As with any investing, there is the possibility for loss as well as gain.

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