# October 2009 – What About Fixed Income Investments?

While it is heartening to see the strong equity performance of the past two quarters, many investors (including us) are a little shell shocked by the wild fluctuations in equity markets over the past two years. We are still 30% below the highs the S&P 500 Stock Index reached in October 2007. Consequently, despite the recovery in the last two quarters, investors continue to grapple with how to prepare their portfolios for the future, and we are now getting more questions about fixed income investments. What role should they play in your asset mix going forward? Would they help preserve capital better than stocks? Wouldn't a steady income stream be better than the uncertainty of stock prices?

Unfortunately, there is not a standard answer. It depends on each investor's goals, risk tolerance and time horizon. To help you sort out how fixed income investments might fit in your portfolio, we thought a brief discussion of them would be timely.

The most common fixed income investments are bonds. They are debt obligations of the issuing entity that have a maturity date (when you get your money back) and an interest rate. Treasury bonds issued by the U.S. are considered the safest. Municipal bonds are issued by local taxing authorities such as cities, counties and school districts and usually their interest payments are tax free. Corporations are also big issuers of bonds. For all bonds, the interest rate paid is based on the perceived risk and on the length of time for which the money is borrowed. Usually the longer the holding period or the higher the risks, the higher the rate will be. Once a bond is issued, its price fluctuates based on general interest rate changes and risk assessments. Bond prices move in the opposite direction from interest rates and risks–as they rise, bond prices go down and vice versa.

Another common fixed income investment is corporate preferred stock. This security has characteristics of both equity and bonds. Since it is a type of stock, it generally does not have a maturity date (unless it has redemption provisions) and, like a bond, it usually has a stated rate of return (preferred dividend rate). Consequently, because of the lack of a maturity the stated rate on preferreds is usually fairly high.

In considering both bonds and preferreds, it is critical to correctly identify who the actual issuer or responsible party is. Many such securities are not general obligations of the entity they are identified with but are payable only from dedicated revenue streams such as an airport or from a special purpose entity and do not provide the protection of the full stockholders' equity of the parent company or the full faith and credit of the governmental body.

In considering fixed income investments, we believe that the two most important factors to consider are safety and the real rate of return–the return after adjusting for inflation. U.S. Treasury issues are considered to be the benchmark for safety. All other bonds are priced based on the perceived difference in safety from treasuries–thus you hear about the "treasury spread" which is the difference between the rate of interest on a bond and the interest rate of a treasury with the same maturity.  Corporate bonds are very difficult to price correctly. It requires a great deal of analysis and as we saw in the recent financial crisis, even the rating agencies were wrong on a number of issues which defaulted and left investors with huge losses. Municipal bonds can also be difficult, as any holder of California bonds can attest. A critical factor for all fixed income investments is whether the rate of return from the investment will outpace inflation for the holding period. If it does not, the investor is actually losing purchasing power with the investment. The quandary is, the safer the investment, the lower the rate of return. Thus long-term government bonds have the largest risk of having negative real returns over their life. In fact for about half of the last 80 years, long-term government bonds have had a negative real return. In addition, corporate and municipal bonds are usually purchased and sold in a more inefficient market (the secondary market). The practical effect is that your yield is lower than what it otherwise should be. Preferred stocks are generally traded on exchanges and, thus, generally trade more efficiently than bonds.

So what should you do in your portfolio? If you are still skittish about the stock market, you might consider putting 30% to 40% of your portfolio into FDIC insured certificates of deposit (CDs) or short-term treasuries. We have also been using several Exchange Traded Funds (ETF) which invest in U. S. Treasuries with maturities of less than three years. Further, if you have a shorter time horizon because you are in or are nearing retirement, a higher allocation to fixed income might be in order. We also recommend Treasury Inflation Protection Bonds or "TIPS" for most tax deferred retirement portfolios. These bonds have a stated rate of interest and also adjust the principal amount of the bond daily for inflation.

Corporate bonds and preferred stocks can be good investments, but they may not be appropriate for some investors. The risk inherent in their pricing and the devastating effects on returns of a single default present risks that average investors don't need. There are many analyses circulating today that tout long-term treasury bonds as having higher historical returns than stocks. While for some selected periods that is true, for most periods, and for the history of recorded investment returns, it is not. The highest returns on such bonds have come from periods when the interest rate on the bonds was relatively high. As rates declined, the price of those bonds went up giving a total return which was quite attractive. Today high quality fixed income yields are low and the possibility for high returns based on interest declines (and bond price increases) from here seem limited.

We continue to believe that a diversified portfolio of carefully selected stocks will outperform all other asset classes over time. However, we recognize that this is not a one size fits all world. Your portfolio needs to be tailored to serve your individual income needs, risk tolerances and time horizon. In building these individual portfolio plans, fixed income securities can play an important role. It is important that we effectively communicate with each other to ensure that your investment profile is one with which you are comfortable and your portfolio is tailored accordingly. We look forward to talking about these issues as we review your results together.