

The Rodney Dangerfield Investment

Rodney Dangerfield's shtick was to complain that he "...didn't get no respect at all." Bond managers must feel as if they are channeling the late comedian's spirit. Bonds preceded stocks in the development of finance ~ there are written loan contracts from Mesopotamia that are more than 3,000 years old. The bond market is huge, almost as big as the stock market. Bonds saved many portfolios in 2000 through early 2003 as the equity markets tanked. Despite all this, most investors act as though bonds did not exist. Many consultants will not even use the word "bond," preferring to call them "deflation hedges." Advisers load up their clients with exotic, expensive hedge funds that pretend to have the same volatility characteristics as bonds, a sort of processed bond-like product, the Cheez-Whiz® of asset allocation. To us, this disrespect makes no sense.

Investor confusion about bonds results from four psychological issues: (1) bonds are boring, with no potential for excitement; (2) bonds involve math, leading investors systematically to misinterpret what is important to bond returns; (3) people unconsciously assume the bond market is not efficient, in contrast to the stock market; and (4) people irrationally fear bond pooled accounts or mutual funds.

First, the boredom. Bonds do little for the emotional needs of investors. Investors buy a stock based upon the story that it is the next Microsoft. Bonds have no similar possibility of a sudden, unexpected quantum change in your lifestyle. The best thing that can happen with a bond is that you earn the expected income stream and, at the end, get your money back. Their virtue is that this happens with much more certainty and predictability than any return from stocks, but there is no chance of a pleasant surprise.

Second, to understand bonds, you have to understand their mathematical characteristics. Anytime math becomes important, you lose much of your audience. If you do the math, though, you find that the three components of the total return from a bond, in descending order of importance, are: (a) interest on interest, what you earn reinvesting the payments you receive; (b) the interest payments; and (c) the repayment of the principal value. So what do investors obsess about when they buy bonds? The principal value, by far the least important of the three.

Third, people do not understand the efficiency of the overall bond market. The common complaint about bonds these days is that interest rates are too low; if rates rise, bond prices will decline. Why does anyone believe this commonly held opinion will help make money? Most people assume the stock market generally is efficient, promptly discounting new information. If you hear an opinion that Dell is selling many computers so the stock is a buy, you would be skeptical of the usefulness of this information. Why do investors assume the bond market has not similarly discounted their insight that interest rates are too low? Did the professional bond traders at Goldman Sachs and Morgan Stanley not get the word?

Why don't the Goldman Sachs bond traders have your insight into interest rate levels?

Fourth, brokers have sold individual investors on the myth of bond "ladders," buying individual bonds with varying maturities. When a bond matures, you use the cash to buy a longer-term bond at the other end of the ladder. This saves the costs of a pooled account or mutual fund (0.20 percent per year for a bond index fund), but when you buy a bond in the secondary trading market, the difference between the bid and asked prices might be 2 or 3 percent of the principal value. This spread cost may not be apparent to the buyer because the prices for bonds are not easily available online or in the paper. Saving 20 basis points by spending 200 or 300 basis points on the bid-ask spread is a false economy.

The primary selling point for bond ladders, though, is supposedly safety. If interest rates rise and bond prices decline, you do not lose principal value if you hold a bond to maturity and get your principal value back. On the other hand, if bonds decline and you (or other shareholders) sell a bond fund, leading the manager to have to sell underlying bonds, the fund realizes the principal loss. You definitely do not want to own any investment in which the owners are panicky and reacting emotionally to every blip in the market – but that is a good general rule of investing, not an indictment of bond funds versus owning individual bonds. There is nothing inherent about a pooled account or mutual fund that leads to losses. Somebody is holding the bonds to maturity, after all. It is a closed system; the money does not just disappear.

Bonds have traditionally been both a great diversifier and a ballast to anchor your stock portfolio, protecting you from occasional market storms and generating steady income. They are not the whole story, but they are part of the story. You can see our exciting mathematical demonstration of this and review these issues in detail, so give us a call at (503) 419-3938 or contact us through our website at www.sigmainvestment.com. It's a simple matter of respect.