Monthly Investment Commentary

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Stocks started the new year on a sour note, with the large-cap Vanguard 500 Index Fund falling 3.6% for the month, and the iShares Russell mid- and small-cap benchmarks dropping 3.4% and 3.7%, respectively. Foreign stocks fared worse, with the Vanguard Total International Stock Index Fund falling 5.1% and emerging-market equities (based on Vanguard Emerging Market Stock Index Fund) losing 6.3%. Domestic fixed-income did better as the intermediate-term, investment-grade Vanguard Total Bond Market Index Fund gained a robust 1.6% for the month, the Barclays 7-Year Municipal Bond Index rose 0.9%, and high-yield bonds, as measured by the Merrill Lynch U.S. High Yield Cash Pay Index, returned 1.5%. Foreign developed and emerging-markets bonds were both barely in the black as the Citigroup World Government Bond Index gained 0.1% and the JPMorgan GBI-Emerging Market Global Diversified Index returned 0.2%.

Research Team Q&A

We regularly use a Q&A format to address questions from readers about our investment views and current strategy. The Q&A format has the advantages of letting us address questions individually without worrying about being limited by a particular theme or subject and allows readers to focus on areas that are of concern or interest to them. This month we decided to focus on questions we have received about domestic bonds.

Domestic Bond Questions

Q: There has been a lot of demand for fixed income (e.g., strong mutual fund inflows). Is the asset class becoming less attractive? What are the worst-case risks there?

By way of historical perspective, going back 30 years, the worst rolling 12-month loss for the Barclays Aggregate Bond index was 9% (for the 12 months ending February and March 1980). The next worst 12-month periods were the 5% losses for the periods ending June and July 1981. Over longer periods, the downsides are less severe. The worst three-year annualized loss for the investment-grade bond index was 2%, also ending in March 1980. Those were all periods where rates rose sharply in a short period of time, although they were also periods where the starting yields were much higher than they are today, which provided more cushion against falling bond prices.

Today, while credit spreads relative to Treasuries have come down significantly since their peaks in the fall of 2008, they are not trading anywhere near their narrowest-ever levels. For example, high-yield bond spreads are currently just slightly above their 25-year average of 500 basis points over 10-year Treasuries. Similarly, investment-grade corporate bonds are trading right around their long-term (35-year) average spread of 111 basis points above.

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While we don't think there is a great deal of risk in bonds, this does not mean we think they are attractive or undervalued. To the contrary, based on our assessment of the scenarios that are most likely to play out, we think the returns to the broad investment-grade bond index will be subpar over the next five years relative to historical bond returns.

Specifically, given the low current yields and the likelihood of higher interest rates at some point during our five-year horizon, our analysis suggests potential returns for investment-grade bonds over the next five years will be in the 2% to 4% range, annualized. That compares to an 8% average annual return for the Barclays index over the past 34 years. That certainly meets the definition of a subpar return. Although the five-year total return is likely to be at least marginally positive, there is also a risk of losing money in investment-grade bonds over shorter periods during that stretch.

For example, looking at our current five-year scenarios we could easily envision losses in the 5% range over a 12-month period. That would be the likely loss, for example, if the 10-year Treasury yield rises about 1.5 percentage points over the next 12 months, from 3.7% to around 5.2% at the end of the period. (The long-term historical median 10-year Treasury yield is 6.2%, so that would still be a percentage point below the median.)

In terms of a really bad worst-case 12-month return scenario, if we assume 10-year Treasury yields are 220 basis points higher a year from now (at around a 6% yield), and that the Barclays Aggregate Bond index's yield spread over Treasuries increases somewhat, our analysis suggests that the index would have a total return loss of around 10%. We think the odds of that scenario playing out are quite low, but not too low to discount entirely.

Further, in the so-called "spread sectors" (such as corporates and mortgages), there is also the threat of rising risk aversion leading to wider spreads versus Treasuries, which would further depress prices and returns.

These risks are a driving reason that we are evaluating bond positions and funds that have flexibility to make adjustments in a rising-interest-rate environment or give us exposure that can mitigate the impact of rising inflation and/or a falling dollar.

Q: What specifically would you expect from different segments of the fixed-income asset class if/when interest rates start to climb back up? What is the best way to protect against interest rate increases and inflation?

At some point, rates will rise and while that does not seem a near-term risk—due to the excessive slack in the economy and the Federal Reserve's statements about keeping the Fed funds rate low for an "extended period"—it is a scenario we think it makes sense to prepare for. In the fixed-income arena, a new area of research for us is evaluating funds with either

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an explicit absolute-return focus or with managers who we know have an absolute-return orientation. Generally these funds focus on achieving positive returns even in a period of rising rates, and they use a variety of tools (short-term instruments, derivatives, etc.) to try to achieve that goal. We have selectively been using positions like the PIMCO Unconstrained Bond fund that have the ability to use many tools to hedge some of these risks and will continue to expand our research in this area.

For individual bond portfolios, we would welcome higher rates as we are always thinking with our reinvestment hats on. Our individually managed bond portfolios are "laddered" with maturities usually in each and every year. These maturities need to be reinvested at the then prevalent rates. Over time, this allows one to earn the normally higher rate in the longer-term maturities with roughly half the risk. Overall portfolio rate risk can be measured by the average life and duration statistics. Generally speaking, we believe a 5 to 7-year average life provides the best risk-adjusted returns. Today, given the steep yield curve, we are comfortable buying longer-term maturities particularly tax-free municipals. That said, we prefer higher coupon bonds which are callable. These call features work to constrain the premium one has to pay for a particular coupon. They offer additional yield to the call date or effective maturity and if not called, they "kick" to the higher coupon yield. These are also referred to as "cushion" or "kicker" bonds. Lastly, they are also refunding candidates and have that potential for price appreciation. In agencies, we like step-up coupon bonds which offer basically the same characteristics.

Another option to protect against rising rates would be to shorten the duration of portfolios or to use short-term bond funds. One concern with moving into a short-term bond fund at this stage is that as the market anticipates the Fed raising rates, the yield curve may flatten primarily via short-term yields rising (and prices falling) while long-term yields may not move as dramatically. (This is known as a "bear flattener.") This would be bad for short-duration bond funds and could lead to losses.

Another option to consider is TIPS (Treasury Inflation-Protected Securities). We may increase our TIPS position at some point, but we will not be adding to TIPS at this time as TIPS' real yields are quite low—the 10-year TIPS real yield is about 1.3% to 1.4%. In contrast, the real yield was around 2% in mid-2009, a level that may interest us to buy more.

Q: What is your outlook for high-yield bonds?

GIn late 2008, we raised our outlook for high-yields bonds to a "4" (on a scale of 1 to 5) and began actively using them in portfolios, as we viewed their valuation as quite compelling. Since then, performance has been very strong (relative to stocks and most other types of bonds) as their spreads over treasury bonds has declined from over 20% to a current level of

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around 5%. Here is a quick summary of our high-yield outlook over the near term and longer term: We no longer see high-yield as compelling on an absolute risk/return basis. Relative to equities it still looks somewhat compelling in negative or pessimistic economic scenarios because the short-term downside is very likely less than stocks and the five-year potential return is better. In a base-case scenario, high-yield doesn't stand out versus equities from a five-year return perspective. So we are selectively looking to trim back positions and are likely to continue trimming over the next several months depending on economic factors, performance and our client's risk tolerance.

In some cases we have used high-yield bonds as a substitute for equity exposure, and we still view high-yield as having lower downside risk than equities in a disappointing environment, but still with some potential for decent to good returns in a flat or better economic/ earnings environment. However, somewhere on the spectrum between a "flat" and "better" economic environment the returns for equities are likely to be better than the returns for high-yield.

We continue to closely monitor many different asset classes and look forward to providing you with updates on our outlook in the upcoming months. Thank you again for your confidence in us and please let us know if you have any questions on this commentary or investments in general.

- CB&T Investment Team 2/2010