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Bonds in Uncertain Times

Submitted by Jerome Jacobs on Tue, 07/30/2013 - 9:00am

The recent volatility of bond prices is a reminder that bonds are quite risky, but it doesn't mean that investors should eschew them. There are numerous strategies that can help manage risk and gain returns.

Bond prices fell (and yields spiked) since May, with the Federal Reserve's messages to the market that its days of unlimited asset purchases are drawing to a close. This somehow surprised many market participants. The central bank is still purchasing $85 billion in bonds and mortgage-backed securities to keep interest rates low.

Just the hint that the Fed plans to draw down its stimulus in the future raised fears of a rate hike, which could cut down current bond prices (prices move in the opposite direction from yields). The Fed has since backtracked, and they now say that we need to keep stimulus in place for the foreseeable future. But still bond yields are much higher than they were in May.

Another factor that could affect future bond prices is the increasing probability that the U.S. and global economies expand at a somewhat faster rate starting in 2013's second half and into 2014. A key reason is that fiscal restraint has been a headwind for economic activity so far this year.

For example, in the United States, Congress raised taxes and cut expenditures as we went off the fiscal cliff. On a year-over-year basis, U.S. tax receipts are up over 10% and expenditures slightly negative, resulting in a far more rapid shrinking of the budget deficit than almost anyone anticipated. In June, the government posted a record $116.5 billion budget surplus. As the fiscal headwinds diminish, the pace of economic activity should improve modestly both in the United States and abroad.

Bond markets appear to have stabilized recently with a 10-year Treasury

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By Larry Light, Editor-in-Chief

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bond hovering around a 2.5% yield level. That is still well below historical averages and well below where we think bond yields are headed over the next several years. So we are not exactly jumping in with both feet to add higher grade bonds such as Treasuries into our portfolios.

However, the process of climbing yields will take a long time and will most certainly not happen in a straight, smooth line. More likely, the increase in yields will be a stair-stepped pattern, with episodes of sharp rises in yields followed by periods of consolidation and even retracement.

We are more optimistic with respect to a number of the credit oriented-sectors that sold off even more aggressively and where it's getting compelling to enter. Even so, there is no telling how much more these markets could potentially decline and my firm is scaling our way in with modest and disciplined increments.

Here are four recommended steps for investors to take advantage of bonds amidst the uncertainty about future interest rates.

Barbell the portfolio. This means concentrating your holdings at either end of the maturity range, in short-term and long-term bonds. Barbells are more defensive than laddered structures, where you buy long-term bonds with successive maturities. the barbell strategy gives you the safety of short-term bonds and the yield of longer-term bonds. The short-term ones are less exposed to interest rate changes. This is particularly true if the yield curve flattens, as happens in virtually all major bear markets for bonds. Then, bond yields for all maturities cluster close together.

Senior loan funds. These are extensions of credit to debt-heavy corporations. The funds offer above-average yields since there is more risk, but their yields also float. This means that if interest rates rise, so does your yield. These funds are called "senior" because they take priority in a bankruptcy filing. If the business fails, senior creditors are paid out first. Just like junk bonds, the underlying loans are to companies that don't have access to the traditional credit market, so the risks are higher than with Treasuries.

Hedge against declines. Add allocations to true "risk neutral" alternatives that strive for positive returns in any type of market direction …. up, down or sideways. For instance, the **AQR Diversified Arbitrage Fund** (ADAIX) seeks to profit from betting on mergers, as well as several other types of arbitrage.

Don't over-concentrate your holdings. In particular, reduce, as far as possible, allocations to intermediate, "core" bond positions such as U.S. Treasuries and high-grade corporate bonds. Too often, investors place their entire bond allocation in one area of the market. This is poor diversification. Not all bonds are alike, and if you put a large amount of your savings in one type, or several types that rise and fall together, a change in interest rates could drastically hurt your portfolio.

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