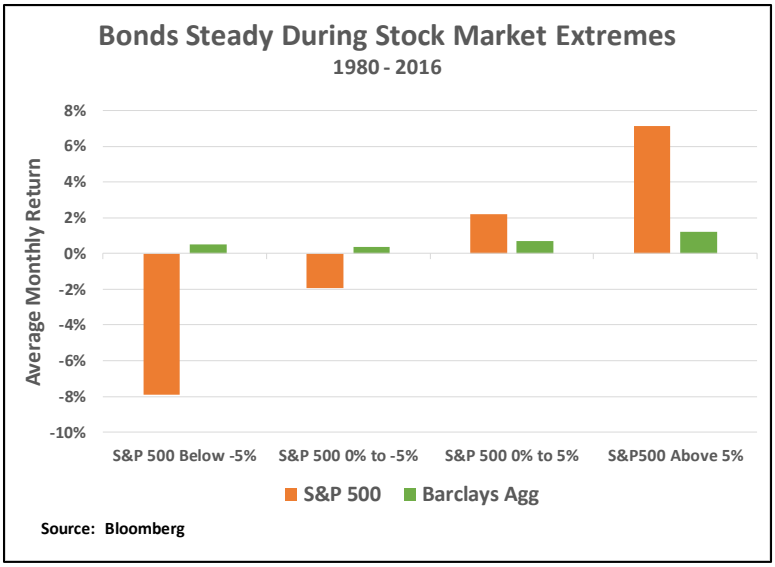
PRESTIGE
WEALTH MANAGEMENT GROUP
Your Personalized CFO

Why Own Bonds?

Bond yields increased noticeably during the 4th quarter of 2016 in an apparent reaction to the election results. Bond investors seem to be expecting higher inflation ahead, and are demanding more yield to compensate. Remember that when bond yields go up, the principal value of bond holdings goes down. The longer the maturity of the bond or bond fund that you are holding, the more it will go down if interest rates rise. Municipal bond yields have seen particularly strong increases because of the concern that lower taxes may reduce their attractiveness relative to taxable bonds.



In recent years, our view has been that the expected minimal additional yield from longer dated bonds does not justify the additional risk involved in extending maturity, so we have been "shorter" than the market for some time. In fact, a few weeks ago we took steps to further shorten up our average maturity. This has dampened our sensitivity to rate increases. Also, in many portfolios we added a short-term TIPS (Treasury Inflation Protected Securities) fund to help protect portfolios against upward inflation surprises. At some point, when we believe the Fed is done ramping up interest rates, we will contemplate extending our maturities to capture higher yield.

Even though yields continue to be relatively low and the total expected return of bonds is dampened in a rising interest environment, they still play an important role in almost any investor's portfolio. Why?

<u>Three Reasons to Own Bonds</u>

Reason #1: For Steady Income. Granted, the current income on bonds is less than what it has been on average historically. However, compared to bond yields in much of the rest of the developed world, U.S. bonds are fairly attractive.

Reason #2: As a Wealth Preserver. Despite the unusual experience of the last quarter, history clearly shows that bonds are much less volatile than stocks. As shown in the graph at right, during those months that stocks have had their most negative returns, bonds have continued to provide positive returns on average. Bonds dampen the overall volatility of a portfolio, which can help investors ride out the roughest market storms. And if stocks have a severe downturn, an allocation to bonds can provide long-term wealth preservation.

Reason #3: As a Diversifier for Stocks. The long-term benefit of diversification has been called "the only free lunch in investing." The diversification benefit that an asset provides to a portfolio is measured with a statistic called "correlation." The correlation between two assets varies between -1 and +1: the lower the better. Bonds have generally done a pretty good job of diversifying stocks historically, although the correlation between the two has varied over time. Since about 2000, correlation has been lower than normal, indicating a stronger diversification benefit.

Conclusion

This quarter has not been a great one for bonds. However, one bad quarter doesn't necessarily lead to another one. In fact, historically bond returns tend to revert back towards average after a quarter like this one. Bonds still have important roles to play in a portfolio: 1) a source of steady income, 2) a wealth-preserving buffer to stock volatility, and 3) a diversifying influence that lowers overall portfolio volatility.

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Roy Williams, ChFC Kevin Means, CFA John DeAngelo, CFP® Alyssa McMahon, MBA, CFP®, CFA