Should Investors Sell All Their Bonds?

SYNOPSIS

- Concerns over rising interest rates have led to more than one market pundit calling for a "bloodbath" in bonds over the coming years.
- Bloodbaths do not happen all that often, and even so, the term is a relative one.
- Investors must always remember why bonds are included in a diversified asset allocation.

currie financial group

The Coming Bloodbath

It seems as if we cannot go a day without hearing about the impending destruction of the bond market as interest rates continue to move higher. I have lost count of the number of email newsletters I have received warning that it will be a "bloodbath" in bonds. Let's quickly run through some bond math to see why the fearmongering has become so vocal on the subject.

A bond represents a "fixed" income stream over time. If an investor buys a $100 bond that yields 5%, then they will receive $5 in income each year for the duration of the bond. Assuming no default, this $5 payment will never change.

What does change is the price. If our investor decided that they no longer wanted to own this bond, they could sell it to someone else. Like most things, the value of this bond will change over time based on how attractive it looks to a potential buyer.

One big driver of value is the yield relative to other bonds available to buy. For example, if a year goes by from the original time of purchase, and similar bonds now offer 4% yield, then the older bond paying 5% is more attractive to a buyer because it offers $1 more income ($5 - $4 = $1). Since the bond has more value, the owner of the bond could sell it for a higher price than what they paid.

However, if similar bonds are now paying 6%, then the older bond is going to be worth less because these newer bonds are the ones offering more income. This is the crux of the fear mongers' argument.

They believe that since interest rates will likely rise for several years, current bond prices have nowhere to go but down. Technically speaking, they are correct. Rising interest rates do make older bonds less attractive. However, I strongly disagree that the solution is to sell all bonds for three reasons.

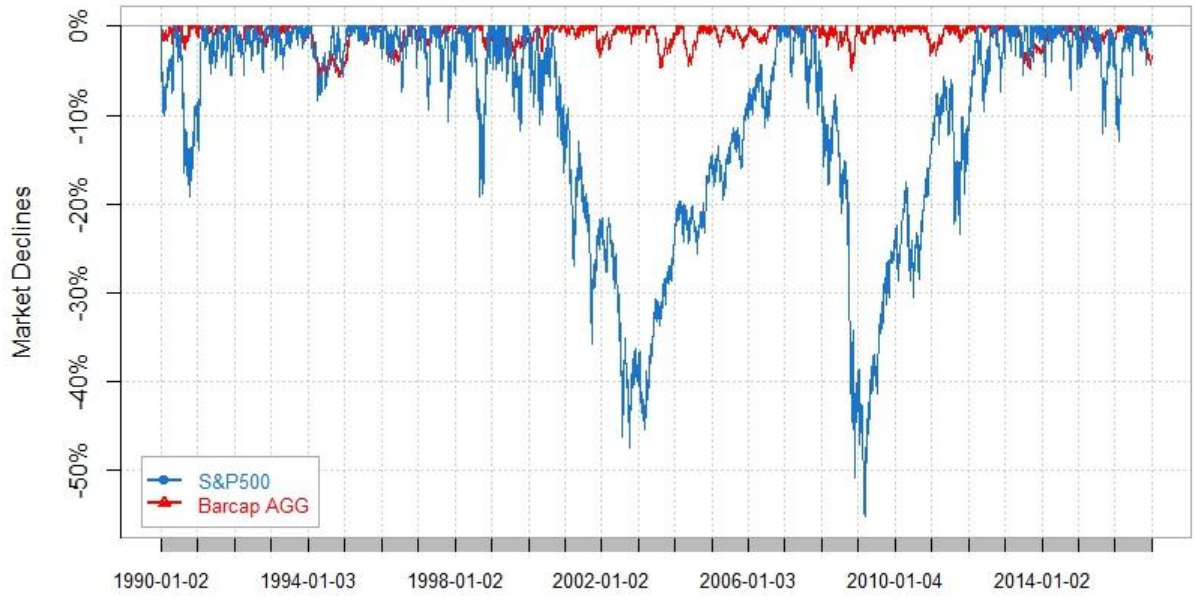
First, bloodbaths just don't happen all that often, so it is difficult to say that trillions of dollars of assets that represent healthy debt issuers have a bullseye on their back. Bloodbaths happen when structural issues exist that introduce other types of risk into the equation, such as default risk. Rising interest rates also mean that our economy is

Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC. SEC registration does not imply a level of skill or training.

improving, and as our economy strengthens, so do the balance sheets of the companies who issued this debt.

Second, the bond market represents several different types of debt. While some sectors, like long-term Treasury bonds, could be in a world of hurt if the Fed moves too fast, not all are primed for disaster. For example, many bonds are linked to inflation or pay higher yields, which can lower their interest rate risk and perform quite well.

Third, the term "bloodbath" is a relative one. The chart below shows the most severe drawdowns since 1990 through February 2017 for both the S&P 500 and the Barclays Aggregate Bond Index, which are proxies for the stock and bond markets respectively.



Source: Bloomberg, Global Financial Private Capital analysis

The market declines in the S&P 500 (blue line) indicate that when it gets bad in the stock market, it really gets bad. Not only did the worst year for stocks lose 38%, but the max drawdown during the financial crisis exceeded 50%.

The red line shows that the bond market's worst year over the same time span was 2.9%, which is roughly 1/13th the size of the worst year for stocks. Hence, although a loss is a loss, relative to equities, the bond market has experienced a fraction of the volatility.

Simply put, even if the fear mongers are right, a bloodbath in bonds is going to look a lot different than a bloodbath in stocks.

Implications for Investors

Investing in bonds was easy for the last 35 years because interest rates fell from the mid-teens down to zero, which practically ensured that the long-term returns would be

Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC. SEC registration does not imply a level of skill or training.

strong. Even a basic strategy of owning a diversified bond index fund yielded impressive returns.

Now that the bond market is about to be turned upside down, there is no question that rising interest rates will create challenges for those investors who are unprepared. However, selling out of them entirely would only make the cure worse than the disease.

We own bonds because they can protect an investor from major drawdowns that are more prevalent in other asset classes like equities. This cushion is critically important to an investor's long-term rate of return for two reasons.

1. **Peace of Mind**: Mitigating big drawdowns in a portfolio helps an investor sleep better at night and lowers the risk of selling in a panic.
2. **Math**: The stock market rises in an escalator but falls in an elevator. This timing mismatch can materially impact long-term returns.

Let's dig a little deeper into the math. If a $50 stock loses 50% of its value in a month, then the stock will trade at $25 ($50 x 0.5 = $25). For the stock to get back to $50, it must double in value ($25 x 200% = $50).

A more recent example is the lead-in to the financial crisis and the subsequent recovery. Per the chart above, the stock market fell over 50% in a matter of months, but then took years to recover. This mismatch in the time it takes to fall versus the time it takes to recover dramatically impacted the long-term returns for many investors who took that ride down.

Therefore, selling out of bonds entirely to avoid the risks that come with rising interest rates is not a viable option because we do not know when the next major drawdown in stocks could occur.

A better solution is to use a new playbook that is specifically designed to navigate a rising interest rate world rather than avoid it. These strategies are sophisticated and require the help from seasoned managers who are skilled at recognizing when risks develop in one area of the bond market and/or when opportunities arise in another. Until the day comes when this new playbook is needed, it's best just to be patient.

The bottom line is that investors are throwing the baby out with the bathwater if they sell all their bonds for fears of rising interest rates. The protection offered from a bond allocation is far too important to eliminate from a diversified portfolio, particularly when strategies exist to help navigate investors over the coming years.

Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC. SEC registration does not imply a level of skill or training.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist, Global Financial Private Capital
mikeonmarkets.com

This commentary is not intended as investment advice or an investment recommendation. It is solely the opinion of our investment managers at the time of writing. Nothing in the commentary should be construed as a solicitation to buy or sell securities. Past performance is no indication of future performance. The author has taken reasonable care to ensure that the information is accurate. Liquid securities, such as those held within DIAS portfolios, can fall in value. Global Financial Private Capital is an SEC Registered Investment Adviser. SEC registration does not imply a certain level of skill or training.

Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC. SEC registration does not imply a level of skill or training.