The Rennie Quarterly Return

Rennie & Associates
Financial Planning
Investment Planning
•••
Volume 2, Issue 1
June 30, 2009

Bonds, the "Dangerfield" of investing

Bonds are the Rodney Dangerfield of the securities spectrum—they get no respect. They are misunderstood, maligned, and shunned particularly by individual investors. However, consider the following:

The US bond market total debt exceeds $27 trillion. This is almost twice the market capitalization of all US stock markets combined! It is the largest securities marketplace in the world.

Bonds are issued to raise money for cities, states, the federal government and corporations. Bonds are purchased by institutions, governments, traders and individuals. Pension Funds typically hold about 40% of their assets in bonds.

The purchaser of a bond loans money to the issuer. The issuer agrees to pay back the loan on the maturity date. They also agree make interest payments, or coupons, on a periodic basis.

Therein lies the most important distinction between bonds and stocks. Bonds have a known terminal value. Stocks do not.

The issuer's obligation to pay is backed by the assets, revenues, or tax authority it possesses. Failure to pay, or default, results in the bond owner having a direct claim against the issuer. Stock holders share in anything left after bond owners get paid, which usually isn't much.

Companies such as Moody's and S&P rate a bond issuer's ability to pay. However, as recent events have shown, they can be caught by surprise. Most institutional investors do their own due diligence.

Bond Prices

Because the terms, coupon rate, maturity date, etc. are known and fixed, bond prices tend to be less volatile than stock prices. Stock prices are driven by earnings, volatile and uncertain. Bond prices are driven largely by changes in interest rates. At maturity, bonds pay investors their full face value.

Bonds in a Portfolio

In an investment portfolio, bonds are to stocks as the net is to a tightrope walker. The young and ambitious may seek fame by walking sans net. As they become comfortable with the wealth fame affords, they add a net just inches from the ground. Each year, as the rope takes its toll on the body, balance wanes, and the net gets higher. There are no old tightrope walkers performing sans net.

Bonds provide portfolio stability and income. The larger the allocation, the lower the impact of stock market volatility, the more cushion in the event of a fall. In 2008, stocks as measured by the S&P 500 Index declined -37.0%. Bonds, as measured by the Barcap Aggregate Bond Index, returned 5.3%. Over the longer term (since 1926), the average annual return on stocks has been 9.3%; on bonds, 5.3%—over the last 30 years, 9.9% vs. 8.6%.

Bonds or Bond Fund?

An investor may purchase individual bonds, or bond mutual funds. Bond funds provide the following advantages:

Diversification and professional management - few individual investors have the time or expertise to evaluate individual bonds.

Instant liquidity - Individual bonds may be less liquid and difficult to sell.

Automatic reinvestment – coupons (interest payments) can be immediately reinvested at the fund's current yield. Individual bond holders must wait until the cash balance is large enough to purchase a new bond. This "cash drag" can have a dramatic negative effect on long-term returns.

Finally, there is no return advantage associated with holding individual bonds to maturity only to reinvest the proceeds. To the contrary, this is an inefficient replication of a bond fund.

Mortgage-Backed Securities are bonds but with somewhat different characteristics. A detailed discussion covering MBS is left for another time.

E. P. Rennie, CFP®, CFA®
President

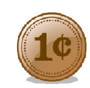
Gary B. Rennie, CFP®, AWMA®
Chief Executive Officer

1608 Galaxy Drive
Newport Beach, CA 92660

Phone: (949) 650-8622
Fax: (949) 650-6683

www.rennieandassociatesfp.com

Email: ecrennie@att.net

Our Two 

"You have to understand that being wrong is part of the [investing] process."

Peter L. Bernstein 1919-2009

Quarterly Trivia:

Four of the 15 richest people in the world have the same last name. What is it?

Walton, a la Walmart