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Not All Bonds Are Created Equal

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In January we pointed out in a research report that the yields on U.S. Treasury bonds currently provide investors with a negative real return. Meaning, that after inflation and taxes, those investing in U.S. Treasuries for the yield to maturity are actually losing purchasing power on the dollars invested.

There is another current risk in Treasuries – interest rates are near their lowest level in decades. So, is it more likely that rates will drop significantly lower or that they will rise in the coming years? Believing rates will ultimately rise exposes Treasury bond investors to "interest rate" risk that can cause capital depreciation. When interest rates rise, the value of (interest rate sensitive) bonds will decline. Treasury bond investors got a taste of this last week when the yield on 10-Year Treasury Notes rose more than a quarter of one percent and prices of those bonds fell precipitously.

We often talk about the risk in Treasury bonds. It is important to remember that Treasuries do not represent, nor necessarily reflect the behavior of, the entire universe of bonds available to investors.

Even with alternative investments and other portfolio hedging techniques, bonds are a traditional asset class that can play a useful role in diversifying a portfolio and mitigating risk in any market environment. It is important, however, to know what bonds you hold in your portfolio and how they will react to different market conditions. Treasuries, for instance, are of the highest credit quality, but are also very interest rate sensitive.

I want to point out that we are largely avoiding Treasuries at this time and have no long-term Treasury bond exposure (those most sensitive to a change in interest rates). Our goal has been to insulate our portfolios from sensitivity to rising rates because of the damage that can be done to a portfolio.

The media, economists, and other financial market prognosticators talk about the "risk in bonds". And, quite frankly, we agree there are risks – in bond sectors like Treasuries. But, there are other types of bonds and income-oriented investments that can be utilized to diversify a portfolio and mitigate risk that will continue to perform well in this environment.

We are aware of, and have been expecting, an inevitable rise in interest rates. As tactical asset allocators, we continue to monitor and analyze interest rates, credit markets, the economy and other factors affecting various bond sectors.