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summaries

SIGMA INVESTMENT COUNSELORS

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Not All Bonds are Created Equal

Bonds can play an important role in one's portfolio; providing certainty of cash flow from interest payments and certainty of principal return, assuming the issuer does not go into default. Moreover, as bonds are not highly correlated to stocks, and are less volatile than stocks, the addition of bonds into a common stock portfolio diversifies the risk and adds stability to the account.

The downside of bonds is that their returns are often in the low to mid-single digits, sufficient enough to usually offset the rate of inflation but in many cases, below the returns needed by investors to achieve their long-term goals. That is why asset allocation is so important; finding the right mix of securities, such as stocks and bonds, where the total portfolio can achieve the desired level of return with an appropriate level of risk.

Of course, not all bonds are created equal. As an asset class and in relation to common stocks and other investments, we tend to portray bonds as a low risk investment. In reality, nothing could be further from the truth. While U.S. government bonds may be considered low risk securities, corporate and municipal bonds contain a significantly greater amount of risk than most investors appreciate.

While there are numerous risks associated with fixed income securities, the three that are most relevant in today's market environment include interest rate risk, inflation risk and default risk.

Interest rate risk is when the price of a bond falls in a rising interest rate environment. If the bondholder wishes to cash in his/her investment prior to its maturity date, he/she may not get back the full par value of the underlying security.

Inflation risk arises when an investor locks in a rate of return over a set period of time which is less than the rate of inflation over the same time period. Thus, the investor's purchasing power may not have been protected by this investment.

Default risk is the chance that the issuer of the bond may be unable to pay the interest payments and/or principal on the bond on a timely manner.

In 2008, the risk of default in corporate bonds was the highest in recorded history. For example, the par value of defaulted debt on a worldwide basis was $430 billion. This far exceeded the combined $310 billion reported in 2001 and 2002, following the bust of dot.com stocks. Equally noteworthy, there were an unprecedented number of near misses among once highly regarded financial institutions

such as Merrill Lynch, AIG, Citigroup, Fannie Mae, Freddie Mac, Bear Stearns, Wachovia and Countrywide Financial. There is no telling the amount of collateral damage if these companies had not been rescued either by being taken over by a stronger competitor or via a government bailout.

While we remain in a fragile economic environment, the number of defaults appears to be moderating from last year's frenetic pace. As credit fears have subsided, corporate bond investors must now contend with interest rate and inflation risk. To better understand interest rate risk, it may be helpful to look at the current yield curve. As reported on Bloomberg.com, the 91-day treasury is yielding 0.05% whereas a 12 month treasury bill is trading at 0.29%. The 5-year, 10-year and 30-year Treasury is yielding 2.25%, 3.42% and 4.36%, respectively. (Yields are as of November 13, 2009). These are particularly low yields, especially at the low end of the yield curve. Thus, if one believes that these "low" rates are temporary in nature and are likely to rise over time, bond prices may be under pressure as rates increase. This could have a particularly negative impact on longer dated bonds than those that are close to their maturity date.

As for inflation risk, imagine being on a fixed income and relying on a bond portfolio to meet your daily living expenses. Assume for this illustration that your bond portfolio consists of predominantly U.S. treasuries with an average maturity of 5 years and a yield to maturity of 2.25%. If the price goods and services rise at a rate greater than 2.25% over the next five years, the income stream from this portfolio may not be able to maintain the same level of purchasing power in the latter years than it provides today.

Many investors, mindful of these challenges, tend to reach for yield to compensate for today's low interest rate. This "reach" may involve the purchase of longer dated bonds than what may be optimal or accepting lower quality bonds that they perceive to be safe. Both actions could have disastrous consequences.

To address these issues, Sigma is pursuing a fixed income strategy that we developed several years ago based on the premise that our clients are comfortable with assuming a moderate amount of investment risk in the stock portion of their portfolios but seek certainty and stability in the bond portion of their accounts. Thus, undue credit risk is not appropriate for most clients.

We manage credit risk in a variety of ways. We review the credit rating of each bond by the credit rating agencies such as Standard & Poor's (S&P) and Moody's, to name a few. Using the S&P rating system as an example, the highest credit quality a bond can receive is AAA. Only U.S. government bonds and a handful of corporations have this rating. From strongest to weakest, an investment grade rating includes AAA, AA, A and BBB. Non-investment grade ratings, from strongest to weakest, includes BB, B, CCC, CC, C and D, with D implying that the bond is in default. The ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

It is important to note that while investors are primary users of credit ratings, the fees paid to the rating agencies are paid by the borrower, creating a potential conflict of interest. As the economy began to decline, investors challenged the rating agencies with regard to their models but the agencies were slow in changing their inputs to reflect a more dire environment. This led to a disconnect between economic reality and the ratings assigned to many bonds. At the time of this writing, various regulatory authorities are reviewing this issue. The European Union and the Australian Securities Commission have taken a leadership position with just announced proposed new regulations relating to rating agencies. The United States Congress is now reviewing credit rating agency reform.

Thus, the use of credit ratings to screen bonds is only a part of the due diligence that we employ when managing bond portfolios. We also do our own analysis of the economy, the health of various sectors, and our intimate knowledge of particular companies and municipalities. As a result, we chose not to participate in mortgage-backed securities despite their once high investment grade ratings and attractive yields. In retrospect, this sector of the market was particularly hard hit over the past two years. While we did not get through this period totally unscathed, from a firm-wide perspective, our portfolios had limited exposure to those bonds that defaulted or could be categorized as near misses.

In addition to bond ratings, we strive for diversification. Within a corporate bond portfolio, we seek to diversify our holdings among various industry groups including industrials, utilities, finance, etc. We also strive to invest in multiple issuers within each sector so as not to put all of our eggs in one basket. Within a municipal bond portfolio, we prefer to own securities in multiple states regardless of the investor's state of domicile. We also favor general obligation bonds over revenue bonds, all else being equal.

While we may have survived the "perfect storm" that hit corporate bonds last year that resulted in a record number of defaults and near misses, our focus has now expanded to municipal bonds. We are trying to be proactive with a common sense approach, recognizing the limitations presented due to a lack of timely disclosure by the municipalities. Our concern is that many municipalities are experiencing a significant decline in their revenues given falling real estate values and declining sales, both of which result in a decline in tax collections. However, many of these municipalities are not able or willing to cut their operating expenses fast enough to maintain a balanced budget. Moreover, new regulations require municipalities to put the value of their employees' pension liabilities on their books. This is sure to change the financial statements for many municipalities and may have a negative impact on their credit ratings. Finally, these municipalities often purchased bond insurance to enhance their credit ratings and marketability of their bonds. As many of these municipal bond insurers are in dire straits themselves, this insurance may prove to be ineffective if municipalities begin to default on

their debt. This is particularly noteworthy as until recently, it was almost unthinkable that a municipality would declare bankruptcy; it just didn't happen. Early signs of these stresses are showing themselves in areas such as the State of California where earlier this year S & P cut the state's bond rating to the lowest amongst states.

Another way in which we are seeking to manage risk in our bond portfolios is by shortening our duration. Generally, we build bond ladders which extend out 10 years or more. Such a ladder creates an average maturity in the portfolio of approximately five years, with the portfolio's duration less than that. (Duration is a way to measure the volatility in a bond portfolio. The higher a bond's interest rate and the longer a bond's maturity the more a change in rates, up or down, will impact the price of the bond. The higher the duration of the bond or the bond portfolio the more volatile the price value of the bond/portfolio.) In today's low interest rate environment, we have favored the shorter end of the yield curve. This decision is reducing the interest rate risk in our portfolios as we are lowering our average maturity and duration in most accounts. The downside to this strategy is that our yield to maturity is taking a hit as well. However, our expectation is that interest rates will move back up to a range which we would deem to be more normal, at which time we will lengthen our bond maturities and re-establish longer portfolio ladders.

Unlike the stock market where securities are traded on a central exchange and prices are readily transparent, the bond market has no central exchange and pricing is largely dictated by a bid ask spread that can vary from one buyer to the next. To compete in this arena, it is helpful to have a trading relationship with many dealers and to be able to buy in bulk to lower the spread. To manage this process, we rely on the experience of Cheryl Kotlarz, a veteran bond manager who has been with Sigma for over 10 years. With Cheryl's guidance, we evaluate bond offerings at Schwab, Fidelity and a number of third party dealers, seeking to get the best price via competitive bidding, where possible. In the fixed income marketplace, every basis point counts!

In conclusion, Sigma is spending a considerable amount of time and energy managing fixed income portfolios, respecting the inherent risks that bonds contain. As an important backdrop, the current environment of economic stress can, and does, meaningfully impact fixed income holdings. We fully understand that "Not All Bonds are Created Equal".

The views in this publication are as of November 2009 and are for informational purposes only. The information presented in this publication is not intended to provide investment advice. Keep in mind that each sector of the market entails risk and statements concerning financial market outlook are based on current market conditions, which will fluctuate.