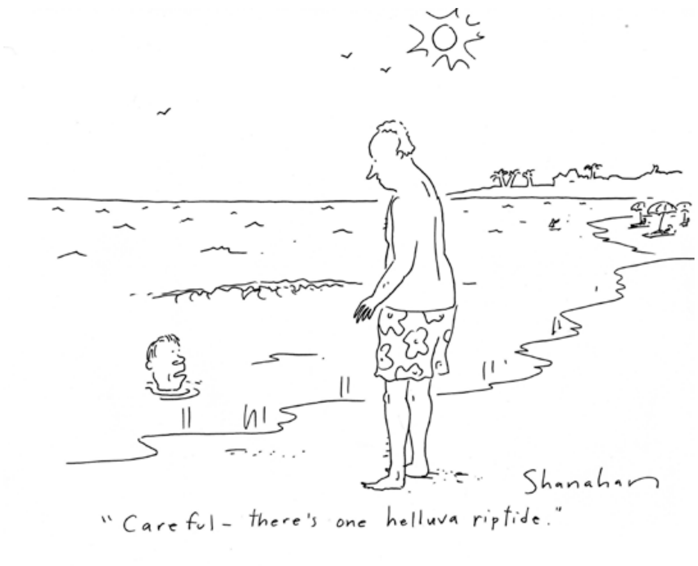
Skilled Investment Managers Back In

"A man always has two reasons for doing anything: a good reason and the real reason."
- *J.P. Morgan*



On March 6, 2009, the S&P 500 index bottomed out intraday at 666.79. I remember the day well. At that time, I was working as a U.S. Treasury bond trader with RBS in Greenwich, CT and preparing to leave within weeks on a long term international assignment for Tokyo. I was concerned given all the doom and gloom in the air that my assignment would either be put on hold or scrapped all together. Thankfully, markets stabilized and I was sent out as planned.

Eight years have passed since, and the S&P 500 index has risen by more than 260% without much of a hiccup along the way. Astonishing. Nowadays, skilled investment managers who excel at managing market risk are out, while those that buy the FANG's (Facebook, Amazon, Netflix and Google) are in. This will not continue forever – nothing does.

Most of the time markets hum along and people get paid to take risk regardless of value. Investing mistakes are made but seldom noticed by non-experts. As the saying goes, “a rising tide lifts all boats.”

I do not know when the next downturn will occur, but given the sharp move higher U.S. stocks have recorded over the past eight years, it would be imprudent not to take precautions. This is also the message from investment advisor, Alan S. Roth who is the founder of Wealth Logic. Mr. Roth wrote an article for The Wall Street Journal this past Spring regarding the importance of including bonds in an investment portfolio. I thought given similar concerns, it made sense for me to share his piece below.

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Why You Need Bonds More Than Ever

By Allan S. Roth

March 3, 2017

New clients are coming to me with the most aggressive stock allocations I’ve ever seen—including in 2007 just before the 2008 stock-market plunge. Many are 100% in stocks and ask “Why would I want bonds now?” They’re convinced that rates are sure to rise and that bonds, whose prices move opposite yields, will get creamed.

I can’t overstate how much this trend concerns me.

I suspect there is a dynamic at play that is similar to what caused many to have an overly aggressive portfolio before the 2008 market plunge. Much like in 2007, stocks today have had a great run, with U.S, shares more than doubling in five years as measured by the total return of the Wilshire 5000, a broad measure of the U.S. stock market. In fact, the current bull market in stocks is far more powerful than the 2007 bull with the total return of the Wilshire 5000 gaining more than 300% in just under eight years.

The Case for Bonds

Investors cite the following arguments for avoiding bonds: Government stimulus and possible trade tariffs under the Trump administration could be inflationary, which would likely cause rates to rise and hurt bond prices. The Federal Reserve has already announced it will be raising its benchmark short-term rate this year, also hurting bond prices. Finally, rates can’t go much lower, can they?

I acknowledge all of these arguments and then tell clients that I’m not budging from my personal allocation to fixed income of 55%. This is not to say they should have that particular allocation, but I’m an advocate of sticking to whatever allocation one selects and not budging based on presumptions about future performance.

Also, it’s important to understand that the Fed directly controls only overnight interest rates on interbank lending. Just because the Fed has announced it intends to continue to increase those rates doesn't mean yields on intermediate- and long-term bonds will follow suit. The market controls those rates.

Fran Kinniry, a principal in Vanguard's investment strategy group, says the three months ended Jan. 31 saw one of the largest flows ever into higher-risk asset classes (generally defined as stocks and junk bonds). Mr. Kinniry says "this trend concerns me given it is on heels of strong bull market and investors not rebalancing, as I am an advocate for high quality bonds and bond funds as part of most portfolios."

My Advice

Individual investors and professionals are really good at timing markets poorly. For example, on Oct. 9, 2007, at the height of the prior bull market, advisers on the TD Ameritrade platform had only 26% of clients' money in cash and bonds. When the market bottomed on March 9, 2009, they had nearly doubled that allocation to 51%.

While I don't know when the next stock-market plunge will happen, I do know it will happen simply because it's part of investing. And when the plunge happens, I suspect investors will wish they hadn't abandoned high-quality bonds. Bonds have bested global stocks so far this century and balance is key to long-term investing success. Bonds serve the role of shock absorber to one's portfolio, allowing investors to rebalance and buy more stocks after any plunge. If, however, economists are finally right and rates do rise, the silver lining is that the yield on bond funds will increase.

I'm not abandoning bonds and am urging my clients to stick with them, too. I tell them that if stocks do plunge or even decline significantly, they'll regret doing otherwise. Never forget that a high-quality bond fund has less risk in a year than stock funds do in a day.

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Sincerely,

Justin Kobe, CFA
Founder, Portfolio Manager & Advisor

Investing in the bond market is subject to risks, including market, interest rate, issuer credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies is impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Diversification and asset allocation strategies do not assure profit or protect against loss.