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RETHINKING THE BOND MARKET

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After more than two decades of a fixed income bull market, 2013 was not a great year for the bond market. Rates bottomed out on May 1st with the ten year treasury reaching a low in yield of 1.61%*. Many bond market mutual funds had negative returns and bond market mutual funds experienced a record $80 billion in redemptions as investors hit the panic button. Since the credit crisis, the bond market has become more complex and will likely reward those who closely study what worked, what did not and why.

Here are some of thoughts from Risk Paradigm Group on where we believe opportunities exist given the performance of the bond market in 2013:

Think outside of your "core" bond holdings - Since 1999, investing in a core bond portfolio which contains at least 85% investment grade bonds has been a successful strategy. From January 2000 until December 2012, the Barclays US Aggregate bond Index had a total return of 6.29%. But in 2013, that streak came to an end: the index fell 2.0% - its first negative calendar-year return since 1999 and worst since 1994*. As a result, bond investors need to rethink their fixed-income portfolio to achieve the same level of success going forward.

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*Source: Bloomberg

Own bonds for more than just returns - Just because core strategies underperformed in 2013 does not mean it was a bad idea to own them in your portfolio. Bonds offer value beyond their returns. Within an asset allocation strategy, bonds offset the volatility of riskier assets and their performance should be viewed in this context. For example, a portfolio with 60% in the S&P 500 Index and 40% in the Barclays US Aggregate Bond Index performed very well, up 18.6% with a level of volatility suitable for many investors.

Flexibility trumped the benchmark - While benchmarked investing worked well enough when interest rates were declining, last year interest rates rose dramatically providing a major head wind to bond returns in 2013. Today, almost every bond index offers historically low yields and the same interest-rate risk as before. The unintended consequence is duration risk or the price sensitivity of the bond to a change in interest rates. A more flexible approach can offer more room to manage that risk.

Limited liquidity is a new head wind - Regulatory changes have impacted the banking sector and its fixed income market-making ability in the secondary markets. This has intensified volatility and should continue to do so. Since 2008 and the financial crisis, the secondary fixed income markets have become more challenged as dealers have lessened their commitment due to capital constraints. With these developments, interest-rate volatility poses a greater risk than higher rates themselves.

The bottom line- Despite, what happened in 2013, investors should not turn their backs on bonds. Bond investors have always sought some combination of stability and income. For the past 15 years, bond investors have had the added benefit of capital gains as interest rates have declined. This all changed as the 10-year US Treasury is less likely to provide the combination of stability, income, and capital gains as it has over the past 15 years. Going forward, navigating the bond market will require a more flexible approach with different portfolio's designed to meet the diverse needs of each investor.

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