

Bonds Are Just Misunderstood

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This article is in response to a [letter](#) to the Editor, and follows up on our [article](#) last week, “The Case for the All-Bond Portfolio.”

Stock investors may not understand bond investing because it requires a different mindset. Bond and stock investors think about investing in different ways. Many bond investors are not total return investors. We do not plan to sell bonds because they have appreciated or depreciated. We do not consider market fluctuations particularly relevant, as long as the decline in value is not reflective of credit quality deterioration. We plan to hold our bonds until they come due.

We don't advocate market timing in bonds. If we were to sell a bond at a gain because interest rates declined, taxes and transaction fees would be incurred. In addition, the investor's funds would have to be reinvested at lower rates. Meanwhile, despite the decline in interest rates, investors are still earning the higher returns and cash flows that we locked in at the time we purchased the bonds. We consider selling bonds if there are other proposed uses for the funds: a tax advantage, more attractive market opportunities, or a decline in credit quality.

Stock investors may fail to grasp the nuances of the yield curve and the diversity available among bonds. Treasury bond 30-year yields are at a 3.5% today (2/25/2009). Investors are fleeing to safety and the liquidity provided by those bonds, despite their unattractive yields. However, other sectors of the bond market that look very attractive. Within the past few months, large institutions have been disgorging large blocks of muni bonds to raise cash, creating opportunities to buy these bonds at distressed prices.



According to The Bond Buyer, the traditional ratio between Treasury bonds and triple-A rated munis has been 85.1 percent. In December of 2008, due to a sell-off in muni bonds and a surge of Treasury bond buying, triple-A 10-year yields reached an unheard of 186.1 percent of the ten-year Treasury. (“Low-Rated, Long-Term Munis Still Floundering,” The Bond Buyer, 2-25-2009) By going out 20 years, an investor could get 5 percent or better tax-free, or about 8 percent pre-tax equivalent yield. [Ed. Note: See our recent [article](#) on “Value in the Municipal Bond Market.”]

Rio Hondo Community College District (Los Angeles, County), a double-A rated general obligation bond issuer, recently sold zero coupon bonds due 8/1/31 at a 6.9% federal tax-free and state-tax free (for California residents and a few other states), with a unit price of 20.09. You could purchase \$1,000 face value for \$200.09, or you could purchase \$25,000 face value for \$5,002. That looks like growth to us.

Of course, if we have inflation the value of these bonds may diminish. A mitigating factor in price fluctuation is that every passing day brings the bonds closer to maturity and their redemption. However, market volatility in bond prices certainly beats losing 50 percent in stocks and then hoping your stocks will recover. Historically, inflation hurts stock prices. During the huge inflation of the 1970s, stock prices crashed early in the decade and didn't improve in price until the early 1980s, once inflation began to decline.

The bond market is huge. Each type of bond has its own characteristics and pricing benchmark. They may move in tandem or independent of Treasury bonds. It is necessary to look beyond Treasuries for your investors and help them to enjoy the benefits of safe bonds.

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