



Will Bonds Be ‘Burnt to a Crisp?’

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Bill Gross’s recent monthly [commentary](#) painted a disturbing picture for investors – he foresees bonds being “burnt to a crisp.” This isn’t just hot air. Such a conflagration is possible, and investors in bond funds, especially those that are constructed similar to the widely followed Barclays bond index, need to heed risks inherent in today’s market.

Understanding the capital flows caused by the Fed’s balance sheet expansion is important – for a refresher, see my earlier [post](#) on quantitative easing, which went through the mechanics of QE3 and how it has affected various fixed-income classes. But the fine points of QE3 are not essential to understanding the full fixed-income universe.

In fact, the lion’s share of the fixed-income universe is not in the segments I discussed in that earlier post but, instead, in U.S. Treasuries and agency mortgage-backed securities (MBS). The common fixed-income benchmark for these is the Barclays Capital Aggregate Bond Index (AGG).

The longer view

Before we delve into the immediate situation in the bond markets, it’s worth considering the bigger picture: If the government does not get its fiscal house in order, the Fed will be stuck printing money to cover its debts. Gross was right in highlighting this problem, and it’s certainly a concern.

Gross, however, went a step farther and asserted that the United States will resemble Greece if it doesn’t conquer its deficits. That is nonsense. The United States is a currency issuer and can never run out of dollars. Greece, in contrast, is a currency user and cannot issue euros.

Investors are coming to the conclusion that our economic problems cannot be solved by monetary policy alone. Fiscal policy will be the key determinant of future economic performance. In the short term, however, Fed policy will be the main driver of fixed-income asset prices.



What's my upside?

As with any investment, it's especially important, given current uncertainty in the bond market, to understand the inherent risk-reward characteristics of a bond.

Consider a Treasury bond maturing August 15, 2022 (10-year proxy), with a coupon of 1 5/8 trading at par, thus a yield of 1.625%. Now let's pretend investors wake up to another round of fears in the Eurozone. Treasury yields plummet, and the 10-year yield falls all the way to 1.25%, which would be a record low.

The price at that point would rise to about 103.50, or a gain of about 3.5%. That's relatively little upside, especially considering the unprecedented lows such yields would represent.

Conversely, if 10-year yields were to rise to 2.50%, the bond would drop to a price of 92.3, or a loss of nearly 8% -- more significant.

The objective of this simple exercise is not to say whether a 10-year U.S. Treasury bond is an attractive investment but, instead, to illustrate a basic fact – current low yields are limiting the upside of further gains in U.S. Treasury bonds.

What's inside the Barclays index?

Given this limited upside – and large potential downside – for U.S. Treasury bonds, let's see what this means for the widely followed Barclays AGG bond index and funds with a similar composition.

The Barclays index is currently made up of 42% government bonds (mainly U.S. Treasury bonds), 31% MBS (primarily Fannie Mae and Freddie Mac), and 24% investment-grade corporate bonds. Geographically, about 92% is U.S. securities, with small amounts in Canadian, German, and Mexican bonds, among others. Because the Barclays index is an intermediate-term bond index, chances are that many "core" bond funds will have fairly similar composition.

The top 10 specific holdings are all U.S. Treasury bonds and make up more than 18% of the total. Through the end of the third quarter, the index had a total return of 3.77%, which is an annual equivalent of 5.08%. Ten-year U.S. Treasury bonds ended 2011 at 1.87% and finished the third quarter of 2012 at 1.64%, so rates on those have fallen modestly. The Barclays index was also affected by tightening spreads in both corporate debt and agency mortgages.

A look inside the Barclays index also reveals that compensation for bondholders taking on prepayment risk is extremely low right now. The second largest component of the index, agency MBS, is trading at record-high prices, because the Fed is purchasing nearly 70% of new issuance. New 30-year 3% pools are trading near \$106, which equates to a yield of



about 2% at current prepayment rates. Spreads on these mortgage bonds versus Treasury or swap yields have been cut almost in half since the Fed announced QE3.

Mortgage bonds are negatively convex, meaning that when rates fall, homeowners prepay, shortening terms and causing prices to rise slowly or not at all. When rates rise, the bond extends in length as prepayments fall, and prices decrease steeply.

Conclusion

The Fed's QE programs have a dramatic impact. There's no shortage of uncertainty, considering the fiscal issues that Gross mentioned and the unprecedented monetary intervention by the Fed.

But I don't see an imminent rise in interest rates as a major concern. Although the Fed has sharply increased the base money supply, this money is not finding its way into the economy. Unemployment is stubbornly high and well above desired levels, while inflation is muted and below levels acceptable to most Federal Open Market Committee members.

The majority of the asset sub-classes in the Barclays index are now very unattractively priced, because they have been distorted by the Fed's large-scale asset purchases. Such a massive intervention by the Fed misprices both credit and duration risk, as institutions are forced to chase yield from a smaller pool of remaining bonds. Understanding the risk-reward characteristics of the underlying bonds found in many bond funds will help investors decide whether they are worthwhile investment candidates.

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