ADVISER INVESTMENTS

Fixed Income Market Commentary
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Bonds Prove Their Mettle—Again!

After a year where stocks surged and bonds lagged, January 2014 demonstrated, once again, the value of a diversified portfolio.

The bond market staged an impressive rally, surprising many investors who had concluded that bonds had little value to offer following 2013's lackluster performance. Those of you who maintained balanced portfolios rather than abandoning bonds have just reaped the rewards.

As we at Adviser Investments have been warning, volatility has returned to the equity markets with a vengeance. The "risk-off" trade that I have referred to in the past was on, and investors found value in bonds in more ways than one. The broad bond market rose 1.5% for the month—a big gain. Many other assets struggled, and investors were reminded that the markets can zig and zag unexpectedly.

In the course of just 20 trading days, bonds demonstrated that they have plenty of life, utility and value, and remain a very worthy complement to investment portfolios. And as February opens, bonds are once again proving their mettle.

Several factors contributed to January's market turnaround and stock market declines. Some originated here at home (a weak employment report and a few notable corporate earnings misses) and others from overseas (China's slowing growth as well as emerging market currency woes).

One event receiving a lot of attention as a possible source of the recent volatility is the Fed's announcement of the second leg of its tapering plan. Some commentaries I've read suggest the Fed's actions sparked an emerging markets sell-off. To that theory, I say remember this—the Fed is supposed to act in *our* best interest, not the best interest of other sovereign economies, and the collateral damage chips may sometimes fall in unexpected places.

The Fed is justified in continuing the tapering of asset purchases because it sees signs of economic improvement and growth here in the United States. If the Fed reversed course and began to add more stimulus, I'd be worried about what it saw to trigger such a move.

Despite some less-than-rosy recent numbers (which may be related more to weather than whether the economy is in trouble), I believe U.S. growth is accelerating. And hand-in-hand with more rapid economic growth should be an increase in interest rates, which typically means a challenging stretch for bonds. We saw this play out to a degree last year, though a lot of the bond market's action was driven by traders repositioning in anticipation of an expanding economy—a move that may have been taken too far, too soon.

What's a bond investor to do? Because I believe that bond yields will ultimately trend higher, I continue to avoid the longest end of the maturity curve. Twenty- and 30-year bond yields may look attractive at the moment, but the risks of price loss are too great relative to the small yield advantage they provide.

Barclays Fixed Income Index Total Returns Through 1/31/14

	Duration	Jan	Return '14	Return '13	Return '12	Return '11
US T-Bill Index	0.31	0.01%	0.01%	0.10%	0.12%	0.15%
US Treasury Index	5.08	1.36	1.36	(2.75)	1.99	9.81
US TIPS Index	6.84	1.98	1.98	(8.61)	6.98	13.56
US Aggregate Bond Index	5.52	1.48	1.48	(2.02)	4.22	7.84
US Govt / Credit Index	5.70	1.46	1.46	(2.35)	4.82	8.74
US Credit Index {A2}	6.75	1.68	1.68	(2.01)	9.39	8.35
US High Yield Index {B1}	4.08	0.70	0.70	7.44	15.81	4.98
Caa component	3.34	0.71	0.71	13.82	18.34	1.18
Emerging Market ($$) {BAA3}	5.75	(0.28)	(0.28)	(4.12)	17.95	6.97
Municipal Index	8.15	1.95	1.95	(2.55)	6.78	10.70
Municipal Index - 5 Year	3.90	1.05	1.05	0.81	2.96	6.93
Municipal Index - Taxable	10.65	3.97	3.97	(5.75)	10.86	20.42

Source: Barclays Capital

I remain focused on the 10-year-and-under range and avoiding those sub-3% fixed coupon rates. This means paying a premium dollar price, but the benefit of additional income helps offset duration (price sensitivity) by adding higher cash flows. Most of all, be thoughtful about structure. Bonds' prices rise and fall, but barring any defaults, *they are always drawn back to par value* ($100) as they approach their maturity dates. I am structuring portfolios that will generate frequent liquidity events (bonds maturing) so that I can reinvest proceeds in bonds with the higher yields that I expect we'll see in the not-too-distant future.

Finally, don't forget what happened to stocks and bonds in January. In my opinion there is no clearer example of why investors *need* to remain diversified and to maintain a thoughtful allocation to bonds. The shock absorbers in our portfolios have certainly earned their keep over the past several weeks.

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