WEBB ASSET MANAGEMENT

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Monthly Commentary

SYSTEMATIC, PROVEN & RELIABLE

Commentary

The Risk of Bonds

There is an insatiable appetite for yield. Flows into bond funds have dwarfed those into stock funds. Is the crowd being smart or running in the wrong direction?

It is hard to see the positive reward/risk of bonds. US treasury bonds currently yield the following: 3 year .7%, 5 year 1.3%, 10 year 2.7%, and 30 year 4.3%. This is an inadequate interest rate for the following reasons:

1) The credit quality of the US government and most other developed nations is questionable. What rate do you charge a borrower with a $1.5 trillion structural deficit?
2) Quantitative easing will most likely result in inflation when the velocity of money increases.
3) A continued economic recovery will increase interest rates.

Given the above, I am going to make the assumption that interest rates will not go lower. Thus what are the risks of owning treasuries if interest rates increase? Below are the declines in principal values of various maturities of treasuries if rates were to increase +1%, +2%, or +3%:

US Government Treasuries:

	Reward (coupon)	Risk (decline due to increase in rates)		
		+1%	+2%	+3%
3 year	.7%	-3%	-6%	-8%
5 year	1.3%	-5%	-9%	-13%
10 year	2.7%	-8%	-16%	-22%
30 year	4.3%	-15%	-27%	-36%

The reward/risk does not seem adequate. If you assign only a 50% probability to a +1% increase in rates over the next 2 years your expected total return from owning a treasury bond would be approximately 0% at every maturity. If you assign a 100% probably to a +1% rate increase over the next 3 to 4 years your expected total return from owning treasury bonds would be approximately 0% at every maturity as well.

One thing particularly risky about treasuries is that given the current absolute low interest rates, the durations at all maturities are longer. This means that if rates rise the declines in principal will be larger than the last significant rate rise in 1994.

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Commentary

The Risk of Bonds continued…

Now you might say you do not own treasuries but rather higher yielding corporate bonds, Currently, investment grade bonds yield an approximate 1.6% over treasury rates, while non-investment grade bonds yield an approximate 4.5% over treasuries. These spreads are marginally higher than the long-term averages. Thus there might be some capital appreciation potential from a continued narrowing of spreads.

However ex-the narrowing of spreads, corporate bonds have basically the same risks as treasuries.

US Investment Grade Bonds:

	Reward (coupon)	Risk (decline due to increase in rates)		
		+1%	+2%	+3%
3 year	2.3%	-3%	-6%	-8%
5 year	2.9%	-5%	-9%	-13%
10 year	4.3%	-8%	-15%	-21%
30 year	5.9%	-13%	-23%	-31%

US Non-investment Grade Bonds:

	Reward (coupon)	Risk (declines due to increase in rates)		
		+1%	+2%	+3%
3 year	6.2%	-3%	-5%	-8%
5 year	6.8%	-4%	-8%	-11%
10 year	8.2%	-6%	-12%	-18%

The reward/risk is more attractive for corporate bonds due to: 1) a higher coupon (reward), but also a lesser decline (risk) from an increase in rates. Due to corporate bonds higher interest rates, corporate bonds have lower durations than treasuries for equal maturities. The reward/risk for corporate bonds looks better but one still has to ask if it is enough.

You might be tricked by looking at the table of non-investment grade bonds and assuming the reward/risk is adequate. This table does not take into account credit losses. The reason spreads are high on non-investment grade bonds is due to the higher expected credit losses. This substantially lowers the reward.

In conclusion, there are many reasons to believe that interest rates will rise. Given the all time low absolute yields one should ask if the reward/risk is adequate. Will you make a positive return owning bonds? Low rates have lengthened the duration of all bond maturities thus increasing there risk. Thus when rates raise the % decline in bonds will be much greater then historical declines.

- Derek Webb