Don’t Overlook Bonds

What comes to mind when you think of bonds? For many investors, bonds are “boring” or “dull.” However, in many ways, bonds are supposed to be boring. With that said, they play an important role in a well-diversified portfolio. In this issue of Investment Insights, we will discuss two important roles that bonds play in a well-diversified portfolio.

Are Stocks Always Better Than Bonds?

With the recent strength in the stock market and relatively low interest rates, it may be tempting for many investors to abandon bonds altogether. However, we believe, Benjamin Graham’s advice in the 1949 book titled “The Intelligent Investor,” remains applicable today: “We have suggested as a fundamental guiding rule that the investor should never have less than 25% or more than 75% of his funds in common stocks, with the consequent inverse range of between 75% and 25% in bonds.”

We agree with this advice and believe that bonds play a crucial role within an investment portfolio. Income and increased diversification are two of the main reasons bonds play an integral role in portfolio construction.

Key Points

- Bonds play an important role in a well-diversified portfolio;
- Two of these roles include potential for regular income and possible lessening volatility in an investor’s portfolio;
- Bonds are, however, not without risk. We discuss two of the possible risks associated with owning bonds; and,
- A professionally managed bond strategy may mitigate these risks.

<table>
<thead>
<tr>
<th></th>
<th>1 Yr</th>
<th>3 Yr</th>
<th>5 Yr</th>
<th>10 Yr</th>
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</thead>
<tbody>
<tr>
<td>U.S. Large Stocks</td>
<td>19.88</td>
<td>10.25</td>
<td>13.72</td>
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<td>U.S. Small Stocks</td>
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<td>U.S. Bonds</td>
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<td>2.22</td>
<td>4.32</td>
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<td>Intl Markets Stocks</td>
<td>21.66</td>
<td>3.46</td>
<td>6.87</td>
<td>1.86</td>
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<td>Intl Emerging Mkts Stocks</td>
<td>26.93</td>
<td>3.85</td>
<td>4.67</td>
<td>2.40</td>
</tr>
<tr>
<td>U.S. Inflation (CPI)</td>
<td>1.67</td>
<td>0.97</td>
<td>1.23</td>
<td>1.65</td>
</tr>
</tbody>
</table>

Source: Morningstar. Annualized returns for periods ended September 13, 2017. U.S. large stocks is the S&P 500 Index, U.S. small stocks is the Russell 2000 Index, U.S. Bonds is the Bloomberg Barclays US Aggregate Bond Index, Intl Developed Markets is the MSCI All Country World Index Ex-US, International Emerging Markets is the MSCI Emerging Markets Index. Returns include dividends and interest. Past performance is not an indication of future results. All indices are unmanaged and may not be invested into directly. The Indices mentioned in this report are unmanaged, may not be invested into directly and do not reflect expenses or fees.
Income

Earning income can be an important goal for many investors. Bonds are a debt investment which represents a loan to an issuer. These issuers, typically governments or corporations, in return pay back the investor their investment (par value), and in most cases also provide regular interest payments (coupon payments). Unlike common stock, which is generally assumed to have infinite life, most bonds have a finite life as they have a set maturity date. The finite life, in turn, makes bond valuations relatively simple, computed as the present value of bond’s future cash flows. Therefore, bonds can provide investors with relative certainty as they know when they may be expected to receive the par value (usually $1,000) as well as the timetable for when they may receive the interest payments.

Exhibit 1 below shows the income and capital components of annualized returns of US equity and US fixed income. While the annualized return for US equity from 1926 to 2014 is comprised of both income and capital appreciation, more than 90% of annualized return for US fixed income during the same period was made up of income.

Diversification

Bonds are often said to act as a ballast for an investor’s portfolio during times of volatility in other asset classes. There is a good reason for this analogy, as bonds offer the potential to dampen the volatility of a portfolio. The prices of bonds can fluctuate for a variety of reasons including but not limited to changes in interest rates or changes in credit quality. That said, in general, the variation in bond prices tend to be smaller relative to the variation in stock prices. The smaller variation in prices, on average, make bonds less volatile than stocks.

The standard deviation can be used as a measure of volatility. Overall, a higher standard deviation indicates higher volatility whereas a lower standard deviation indicates lower volatility.

Exhibit 2 below shows the average rolling 1-year annualized standard deviation for US stocks for the last 17 years is approximately 13.29%, whereas, the average rolling 1-year annualized standard deviation for US bonds is approximately 3.31%. In other words, on average US stocks have been about four times more volatile than US bonds over the last 17 years. That’s why we like to say the worst years in the bond market are usually better than some of the worst days in the stock market!

Exhibit 1. Income and Capital Components of Annualized Returns Over 5– and 20–Year Rolling Periods, 1926-2014, U.S. Equity and Fixed Income

Source: Brandes Institute, based on data from Ibbotson Associates, Global Financial Data, Inc. and Factsheet, as of December 31, 2014. All return series measure accumulated return assuming an initial hypothetical investment of $100. Past performance is not a guarantee of future results.

Exhibit 2. Rolling 1-Year Annualized Standard Deviation

Source: Morningstar. Standard deviation is a measure of volatility. It may not be indicative of future risk, and is not a predictor of returns.
The relatively less volatile nature of bonds make bonds a potential defensive asset in a well-diversified portfolio. An example of a benefit of having bonds in a portfolio can be illustrated using a 50/50 stock and bond blend portfolio.

Exhibit 3 below shows various ranges of stock, bond, and blended total returns. A 50/50 blend portfolio comprised of stocks and bonds has not suffered a negative return over any five, ten, or twenty-year rolling period in the past 66 years. In contrast, a portfolio comprised of 100% stocks and a portfolio comprised of 100% bonds have experienced negative returns over a five-year rolling period during the same 66 years. Furthermore, the range of returns for a 50/50 portfolio has been smaller than a portfolio comprised of 100% stocks, or a portfolio comprised of 100% bonds for any one, five, ten, or twenty-year rolling period in the past 66 years.

Potentials Risks

So far we have illustrated two benefits of owning bonds. These benefits include the potential for earning regular income and the potential to dampen volatility. With these benefits in mind, it is also important for investors to beware of potential risks involved with owning bonds. Two of the potential risks of owning bonds include credit risk and interest rate risk.

Credit risk refers to a bond issuer going into default before the bond reaches maturity and is unable to pay some or all of par value or coupon payments. Credit rating agencies, such as Moody’s, Standard & Poor’s, and Fitch, analyze the financial stability of the issuer and its ability to pay par value and coupon payments. Based on their analysis, the credit rating agencies assign a bond rating. Overall, bonds with higher credit ratings indicate a lower likelihood of the issuer not meeting their par value and coupon payment obligations. Conversely, bonds with lower credit ratings indicate a higher likelihood of an issuer not meeting their par value and coupon payment obligations. Investors should keep in mind that credit ratings are not a recommendation but merely an opinion of an issuer’s ability to pay par value at maturity and coupon payments.

Bond investors should always be aware of potential interest rate risk as bond values are inversely related to interest rates. The inverse relationship between bond prices and interest rates can be confusing. Let’s examine this relationship from the perspective of the bond holder. Imagine you own a bond and interest rates decrease. New bonds issued in the market will have lower

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**Exhibit 3.** Range of stock, bond, and blended total returns annual total returns, 1950-2016

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<tr>
<th></th>
<th>Annual avg. total return</th>
<th>Growth of $100,000 over 20 years</th>
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<tbody>
<tr>
<td>Stocks</td>
<td>11.1%</td>
<td>$823,015</td>
</tr>
<tr>
<td>Bonds</td>
<td>6.0%</td>
<td>$318,764</td>
</tr>
<tr>
<td>50/50 portfolio</td>
<td>8.9%</td>
<td>$553,221</td>
</tr>
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</table>

yields as compared to the older bonds you own. Therefore, the older bonds you own are worth more. Conversely, when interest rates increase the new bonds in the market will have higher yields, making the older bonds worth less, resulting in lower bond prices. If a bond holder sells their bond before maturity, it may be worth more or less than its original value.

Professional Management

In the last section, we discussed two of the possible risks associated with investing in bonds. A professionally managed bond strategy may manage these risk. Starting with credit risk, the credit ratings provided by credit agencies are subject to review and can be changed at any time. A professional manager monitors these ratings and may also conduct in-house credit analysis to manage credit risk. Next, regarding interest rate risk, the Federal Reserve controls short-term rates, whereas bond prices reflect long-term rates. These rates do not always move in the same direction at the same time. A professional bond manager continuously monitors the prevailing interest rates and determines the optimal mix of bonds for the portfolio, given the current interest rate environment.

While the risks mentioned above cannot be completely avoided, we believe that professional management can mitigate these risks. The Model Wealth Program, available through Cornerstone Wealth Management, offers professionally managed investment portfolio for a broad range of investors.

Conclusion

There is no question that fiscal, monetary, and geopolitical uncertainties are on minds of many investors today. We believe that while the future cannot be predicted, investors can plan for it by diversifying their portfolios. Bonds play a crucial role in the diversification process within a portfolio along with providing a regular income. Indeed bonds are “boring” or “dull,” but they also provide the comfort of planning for uncertain or even exciting times ahead.

Endnotes

1. Standard deviation is a historical measure of the variability of returns relative to the average annual return. If a portfolio has a higher standard deviation, its returns have been volatile. A low standard deviation indicates returns have been less volatile.

2. Source: Morningstar

Important Disclosures:
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No strategy can assure success or protection against loss.
Past performance is no guarantee of future results.
Stock investing involves risk including loss of principal.
The payments of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.
The Standard & Poor’s 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.
The Bloomberg Barclays US Aggregate Bond Index, which until August 24th 2016 was called the Barclays Capital Aggregate Bond Index, and which until November 3rd 2008 was called the “Lehman Aggregate Bond Index,” is a broad base index, maintained by Bloomberg L.P. since August 24th 2016, and prior to then by Barclays which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States. Index funds and exchange-traded funds are available that track this bond index.

Bonds are subject to credit, market, and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

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