Passive
Capital Management

All Bonds Are Not Created Equal – Characteristics to Consider

The Conclusions

1) The investment advisor representatives at Passive Capital Management, LLC believe that bonds should be used to *preserve capital* and dampen the overall volatility of a portfolio, *not to assume additional credit risk* in an effort to "chase yield."

2) The equity portion of a portfolio can be customized to assume various degrees of systematic risk; generally speaking, the more credit risk one assumes with bonds, the more positive the expected correlations to equities (movements become more synchronized). We want equities and bonds to zig and zag in *different* directions, not the same direction, for maximum diversification benefits.

3) The following variables also matter: liquidity, diversification, duration and after-tax returns.

Keeping It Simple

The investment advisor representatives at Passive Capital Management, LLC do not like to make things unnecessarily complex. *Additional complexity is only helpful if it increases the odds that our clients will accomplish their investment objectives.* When evaluating various fixed income alternatives, we believe that high-quality, short-duration, liquid bonds are the best tools to use for a variety of reasons.

Safety: We do not believe that investors should own bonds to enhance returns due to higher credit risk. All else being equal, the more credit risk one assumes in a bond portfolio, the more likely it is that these bonds will go down along with equities in the next bear market. It is important to own assets that tend to go up when equities go down. If an investor wants to increase expected returns by taking more credit risk, we believe it is more prudent to do so in the equity portion of the portfolio. For example, an investor might increase allocations to small cap equities, value equities and/or emerging markets equities to increase systematic risk and increase long-term expected returns. In our opinion, bonds should not be owned for returns or yield; they should be used to preserve capital, dampen volatility and provide liquidity during the next equity market storm.

Correlation: It is important to own assets that tend to go up, or at least maintain value, while your equity assets go down. Based upon historical data, we believe that the high-quality, short-duration bonds we use in portfolios have the highest likelihood of accomplishing this goal of "negative correlation" for our clients. There are no guarantees that historical relationships will hold into the future and correlations can and will change over time; however, short-duration bonds that are high-quality with good liquidity are, in our opinion, the most prudent tool to use. Keep in mind that we are not inherently attracted to securities issued by the U.S. government or any other organization. *What we care about is how an instrument, and an asset class, behaves relative to other asset classes – that's what it comes down to ultimately*. The investment instruments are simply tools that enable us to help our clients achieve their goals; they are means to the end.

Over the past 10 years, 5 years and since the Lehman Brothers bankruptcy in September of 2008, short-duration Treasury bonds issued by the U.S. government have had the most negative correlations to global stocks while long-term corporate bonds and municipal bonds have either had less negative correlations or even positive correlations to global stocks. For example, in the 4th quarter of 2008 when equity investors around the world panicked, Treasury bonds went up in value while many types of municipal bonds went down in value. Some high yield corporate bond funds plunged in value along with stocks. If a bond instrument is going to go down in value along with stocks, why not just own more stocks? It is important to note that some types of corporate bonds and municipal bonds have generated higher returns than Treasury bonds over the past 1, 5 and 10 years due to their higher risk profile (more credit risk and more liquidity risk). Again, we believe returns are not as important as correlations and liquidity when evaluating bond instruments. (Data Sources: Dimensional Fund Advisors, Standard & Poor's, Barclays Capital)

Liquidity: Having the ability to sell a portion of your bond portfolio without impacting market prices is very important when rebalancing a portfolio or if an unexpected event takes place that requires cash. On one hand, many municipal bonds tend to have poor daily (or even weekly and monthly) liquidity, so in order to convert a particular bond to cash an investor might have to accept a significant discount to the stated or assumed value. For example, how many of you are in the market for New York State Dorm Authority Bonds Due 2014 during any given day, week or month? On the other hand, Treasury bonds have excellent liquidity because investors from all around the world are buying and selling the various types of these bonds on any given day. When investors around the world panic and equity indexes fall, it is common to see investors buy Treasuries for the perceived safety and liquidity that they provide (stocks down in price, Treasuries up in price – a "negative correlation"). Investors should only be willing to give up liquidity if they receive something of value in return (for example, higher returns) but, as we witnessed in 2008 and 2009, they should not give up liquidity on too much of their portfolio.

Diversification: Different types of bonds have different characteristics and they can zig and zag in different ways. We believe it is prudent to diversify bond allocations across different types of high-quality, short-duration instruments that tend to have negative correlations to equities over time. For example, short-term Treasuries, long-term Treasuries, the highest quality global corporate bonds, municipal bonds and inflation-protected bonds all have unique risk, return, correlation and liquidity characteristics.

Duration: The "duration" of a bond is generally measured in years and it gives investors a sense for how sensitive a bond will be to interest rate movements. Longer duration bonds tend to be more volatile because they have greater sensitivity to movements in actual and expected interest rates. The sensitivity to interest rates is driven by the timing of when an investor receives the cash flow (interest payments and principal) from the bond; the further into the future the interest and principal payments, the longer the bond duration and the higher the sensitivity to changes in interest rates. While longer duration bonds tend to offer higher yields, all else being equal, these bonds tend to be much more volatile than shorter duration bonds. We do not believe it is worth assuming the higher volatility of longer duration bonds for the slightly higher yields. Again, we do not use bonds for yield and gross return; we use bonds to: safely preserve capital in a liquid manner, reduce portfolio volatility and enhance the risk-adjusted returns of the overall portfolio.

Taxes: The *goal for any investor should be to maximize after-tax returns for a given level of risk*; this can be very *different than trying to minimize taxes*. Investors shouldn't want to reduce the after-tax growth of their net worth simply to spite the government and minimize the taxes paid; don't let the tail (taxes) wag the dog (having the most appropriate, diversified, liquid portfolio possible). Municipal bonds can generate tax-free interest and, on the surface, this is very appealing, especially to investors in the highest tax bracket. However, it's important that investors realize that many types of municipal bonds have poor liquidity and can, therefore, be expensive to both buy and sell (assuming there is a buyer when you're selling). Even if one assumes that they will hold a municipal bond to maturity and there is no need for liquidity prior to maturity, it is important to evaluate the tax-adjusted returns. For ease of comparison, assume Bond A yields 3% and it is entirely tax free so the after-tax yield is also 3%. Next, assume Bond B yields 4.5% and the investor pays a marginal tax rate of 30% on this interest payment; the after-tax yield would be 3.15% (4.5% x (1 – tax rate)). Bond A would enable the investor to minimize the taxes paid to the government because it is completely tax free. Alternatively, Bond B would generate a tax liability but it offers a more attractive after-tax return of 3.15%. *Taxes are one factor to consider* when structuring a bond portfolio but, in our opinion, it is not the most important factor; *we believe that correlations and liquidity are more important, especially when considered within the context of the overall portfolio and a disciplined rebalancing strategy.*

Let Bonds Be Bonds – That Is To Say That They Should Be….Relatively Boring, Safe and Liquid

In sum, *investors need bonds to act like bonds when the inevitable bear markets arrive*. As bonds maintain value or appreciate, investors can then trim their positions and reinvest in equity asset classes that have recently fallen in value in order to maintain their strategic asset allocation targets. This is the essence of our rebalancing strategy that negates the impact of emotions and forces investors to trim recent winners (sell high) and add more money to recent losers (buy low). The negative correlations and high liquidity of the bonds we use enable us to implement this rebalancing strategy on behalf of our clients. Please visit www.passivecapital.com and read The Re-Balancing Act of Investing for a detailed explanation of our approach to rebalancing written by Mimi Boblitz (or email Mimi at mboblitz@passivecapital.com for a copy of her newsletter).

We believe that investors should own stocks for exposure to the systematic risks and the higher expected returns over time, while they should own bonds for the preservation of capital, negative correlations to equities, and liquidity.

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