

## **7Twelve: Bonds**

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So, what is a bond, and how does it differ from a stock? A bond is a loan issued as a type of security by an entity which promises to repay the borrowed money at a specified rate and time period. The time period is referred to as the maturity. Bonds typically pay a coupon every six months. Thus, an 8% bond will pay \$40 every six months ( $\$1000 \times 8\%/2$ ). While the price of a bond will fluctuate in response to changes in interest rates (moving up when interest rates decline and falling when interest rates rise) at maturity, the bond will be redeemed at par value.

Unlike bonds, stocks represent ownership in the underlying entity and have an indefinite life. Theoretically, equity investors should earn a greater rate of return than bond investors because they assume greater risk by taking ownership interest in a company. Over long periods of time, this has proven to be true. For instance, between 1990 and 2008 bond returns (20 year U.S. Treasury) averaged 6.1% vs. an average return of 11.7% for stocks (S & P 500). However, there have been decades during where bonds have outperformed stocks.

Fixed Income plays a significant role in our investment strategy. When considering a bond portfolio it is important to keep diversification in mind. An integral component of a strategic investment approach is to include assets with low correlations. By creating a portfolio which includes a variety of non correlated sectors, each with different characteristics, return will be enhanced while risk remains unchanged or may actually decline. We include International Bonds, Aggregate U.S. Bonds and Inflation Protection Bonds in our TPI portfolios because of low correlations. While correlations are not always constant, diversified investors have an underlying advantage during bear markets where typically the stock-bond correlation becomes more negative.

Bonds come in many forms and can serve a variety of roles in an investment portfolio. The Global Fixed Income market is vast with an estimated size of \$85 trillion. The U.S. represents about 38% of that total value. An asset class of this magnitude cannot be ignored. Fixed Income investments range from U.S. Governments, U.S. Corporates, Emerging Markets, Developed Markets, Distressed, Zero Coupons, Convertibles, TIPS, and Bank Loan funds. Bonds can be classified from both the credit quality and term or maturity points of view. In addition to diversification benefits, bonds can provide liquidity, inflation and/or deflation protection and offer liability matching. TPI believes the Fixed Income Market offers great diversification versus our Equity and Alternative Investment holdings