

Fall 2010

Can Bonds Continue Their Spectacular Run?

Bonds have been trouncing stocks. The S&P 500 lost 5% between 2000 and the end of September 2010, while a well-diversified pool of investment-grade bonds averaged a 6.5% annual return over that period (as measured by the Barclays Capital Aggregate Bond Index).

In fact, that pool of bonds has had a positive return every single year since 2000. And over the past 30 years, the annual return averaged 9.0% (not accounting for inflation).

A 30-Year Bond Rally

The “bond party” has continued this year. Through September, the index is up about 8%. And investors have been chasing the strength. So many investors have been buying Treasury bonds that in just the past six months, the yield on 30-year bonds has been driven down from about 4.8% to around 3.7%.

Mutual fund flows tell a similar story. Bond funds saw inflows averaging \$27 billion per month from August 1, 2009 through July 31, 2010, while stock funds lost an average of \$6 billion per month, according to Ned Davis Research.

But Why?

Many factors have led to this multi-decade bond rally. Stocks haven't provided much reward to investors since the turn of the millennium. And they have also become

more volatile owing to the rise of hedge funds and other high-frequency traders. Not only have bonds provided more reward, they've offered some respite from this increased market volatility.

Another factor supporting bonds is the aging population in most developed countries. Older investors are more likely to have large allocations to fixed income.



Source: Ned Davis Research, as of 10/12/10

The inflation rate has been moving lower over the past 30 years as a result of productivity and globalization. Without concerns about sky-high inflation, bond investors have become more confident about holding longer-duration fixed-rate securities.

Our large trade deficit with China has proved to be an ongoing support for the bond market also. In order to

hold down appreciation of its currency and maintain the imbalance of trade, the Chinese government has poured much of the money it receives from us into US Treasury bonds (the benchmark and anchor for all other bonds).

These are the main factors responsible for the strong performance of bonds over the previous few decades. How many of them will continue to provide support for bonds in the future?

Cloudy with a Chance of Showers ...

Valuations, bonds vs. stocks. Weak stock markets have been providing support for bonds, but stock valuations are more attractive now. In fact, the dividend yields of some stocks exceed the low yields currently offered by bonds. From a relative-value point of view, stocks compare more favorably to bonds than they have for quite some time.

Demographics. Demographics still support bonds. Japan is a good example of an economy that has an aging population and a lot of domestic savers that have continued to buy bonds despite the low yields and arguably poor value.

But the picture here may be slightly more complex given the unknowns. How will public and private pensions respond to their collective “underfundedness”? Will they continue to accept the low absolute yields of bonds or will they roll the dice in equities and other growth assets and try and recoup some of the shortfall?

And how about individual American investors, who tend to be gamblers compared to the Japanese. Will they continue to tolerate 1% yields or will they move into riskier assets?

Inflation. The core inflation rate is about 1% or 2% across the developed world, which has made low bond yields tolerable, but how long will that last? We may see inflation pick up substantially as central banks pump money into their economies in an attempt to counteract deleveraging and spur *some* growth.

Increasing a country’s money supply typically causes its currency to lose value. This can make its exports more competitive in the world market. And buying up sovereign debt generally drops the yields in the bond markets, which causes investors to move to riskier asset

classes. That in turn can create asset bubbles (inflated prices), which may build confidence in the economy. It may also increase the inflation rate.

Reserve currency status. The US dollar has been the world’s “reserve currency” for generations. This has meant solid demand for our bonds regardless of the condition of our economy. While we don’t think another currency will take the dollar’s place, we do expect cash-rich countries (like China) to continue diversifying their currency reserves out of dollar-denominated assets. Likely winners: Gold and other precious metals; sovereign bonds from Europe, Japan, Canada, or Australia; and natural resource assets.

Other risks to bonds. Most Western developed economies are in a horrible fiscal mess. Here in the US, our gross federal debt is about 90% of gross domestic product – and rising. Adding in the debt of Fannie Mae and Freddie Mac takes us to 135%. Not only is this a much greater debt burden than we have had in the past, it is approaching levels that may cause our debt to be downgraded.

The factors we’ve discussed range from the mildly supportive to the downright bearish for bonds over the next decade.

What Does This All Mean for Investors?

Credit risk, interest-rate risk, and currency risk are the three areas of concern for bond investors, any of which could come into play: Interest-rate risk if inflation picks up or investors demand higher rates to hold bonds; credit risk if economic conditions deteriorate and default risks rise; and currency risk for investors holding non-domestic bonds.

To demonstrate how changes in comparative yields (credit spreads) between Treasury bonds and AAA-rated corporate bonds could hurt bond investors, we include a table on the next page to illustrate some of the risk. Changes in credit spreads are shown at the top of the table, in basis points (100 basis points = 1%). Along the side of the table we show changes in the general level of interest rates. Each box on the right contains the predicted one-year total return for a 10-year Treasury bond and a 10-year AAA corporate bond.

Looking at Bond Risk

If you look at the yellow-highlighted box in the table below, you'll see the 2.7% yield you would have gotten if you had bought a 10-year Treasury bond on October 15, 2010. If credit spreads don't change and Treasury yields don't change, you could expect to earn 2.7% over the next year.

		Credit Spread Change (basis points)						
		-200	-100	-50	0	50	100	200
Treasury Yield Change (basis points)	-200 Treasury	20.1%	20.1%	20.1%	20.1%	20.1%	20.1%	20.1%
	Aaa	40.8%	30.0%	25.0%	20.2%	15.6%	11.1%	2.9%
	-100 Treasury	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%
	Aaa	30.0%	20.2%	15.6%	11.1%	6.9%	2.9%	-4.6%
	-50 Treasury	6.8%	6.8%	6.8%	6.8%	6.8%	6.8%	6.8%
	Aaa	25.0%	15.6%	11.1%	6.9%	2.9%	-0.9%	-8.1%
	0 Treasury	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%
	Aaa	20.2%	11.1%	6.9%	2.9%	-0.9%	-4.6%	-11.5%
	50 Treasury	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%	-1.2%
	Aaa	15.6%	6.9%	2.9%	-0.9%	-4.6%	-8.1%	-14.7%
100 Treasury	-4.9%	-4.9%	-4.9%	-4.9%	-4.9%	-4.9%	-4.9%	
Aaa	11.1%	2.9%	-0.9%	-4.6%	-8.1%	-11.5%	-17.8%	
200 Treasury	-11.8%	-11.8%	-11.8%	-11.8%	-11.8%	-11.8%	-11.8%	
Aaa	2.9%	-4.6%	-8.1%	-11.8%	-14.7%	-17.8%	-23.6%	

Source: Loomis Sayles

But now look at the gray box, which shows what happens if the 10-year Treasury bond yield rose 200 basis points (2%). The value of your 10-year Treasury bond, with its 2.7% yield, would drop nearly 12%. This is not a far-fetched a scenario – 10-year Treasuries were yielding 4.5% as recently as October 2007.

Now let's see what would happen if you had bought a 10-year AAA-rated corporate bond on the same date, with a yield of 2.9%. If the Treasury yield went up 2% (gray box) and the credit spread between the corporate bond and the Treasury bond went up 2% (for a total difference of 4%), this corporate bond would be worth almost 24% less (blue box).

The interaction between credit spreads and rates can be played out for many scenarios. However, rates are already very low and it's more likely that they will increase. Credit spreads are already quite narrow and unlikely to narrow much more given the weak growth outlook. This means that the bottom right section of the table presents more probable scenarios.

Conclusions

It's been a great few decades for bonds. Maybe the risk of an imminent sharp jump in rates is low given the Fed's desire to hold down rates until the economic

recovery takes hold (although we're keeping durations short just in case).

Still, we want our clients to understand that it is possible to lose money in bonds and bond funds if rates and/or credit spreads rise and that we think some of the factors that have supported the bond market have weakened or disappeared. This is why we've increased the equity allocations and decreased the bond allocations in some of our client's portfolios.

If you have questions about your situation, don't hesitate to call your advisor.

About the author: Perry Piazza is director of investment strategy, responsible for asset allocation and portfolio development. Previously, he held a number of trading-related roles in New York and London with Citigroup and Morgan Stanley.

What Children Don't Learn in School

Young children learn quickly that money can lead to good things, but where does it come from? A wallet? An ATM machine?

Moving from the magic of the tooth fairy to the real world of earning, saving, spending, and borrowing is an important learning path for your children. Although most of our schools do a reasonable job of teaching the arithmetic of dollars and cents, it's up to parents and grandparents to teach attitudes and values, the concept that things cost money and nothing is free.

Talk with your children about money. Children of families who are financially comfortable often take for granted necessities such as housing, food, clothing, medical insurance, and transportation. It's important to discuss the obligations the family has undertaken for those items, that the house and maybe the cars are paid for over time and that paying for them limits how much can be spent on other things.

When you shop with your children or grandchildren, take the opportunity to talk about why you chose one item over another – or why you decided not to buy anything. If your children see you pass up something you want because it costs a lot and isn't

necessary, it will help them grasp the concept of luxuries and necessities.

As your children grow older, involve them in discussions about more sophisticated financial topics such as insurance and investments. By the time they reach their teens, they should grasp the basic principles of investing and understand the necessity and expense of things like auto insurance.

We encourage our clients to bring their teen or young adult children to meetings occasionally. These older children can gain confidence in dealing with professionals by observing their parents interaction, and they're likely to learn a few things about investing.

Finite resources. One way many families help their children learn about money is to give them an allowance. Children then decide what to do with that finite amount of money. When it comes to saving and spending, they'll discover that if they give in to their impulses and spend it all, they won't have anything left when something exciting comes up. Games help too. In Monopoly, for instance, children learn about earning (passing "Go"), spending (for property), and saving (to put houses and hotels on their properties). They also learn that if you buy too much and save too little, you lose the game.

You can also help your children weigh options and work within a budget by letting them take part in the decisions about the family vacation. Let them discover that if a vacation were less luxurious or a few days shorter, there'd be enough money to buy a big 3-D television that they could enjoy for years.

If you are a business owner, you have an incredible opportunity to teach your children about money. Talk about your business casually in the normal course of life. You will be amazed at how much your kids will pick up about how money is earned, spent, and saved.

Philanthropy. Engaging children in philanthropic activities helps them move from a naturally self-centered world to one that recognizes and cares about others. Talk about some charities in your local area that might interest them, and let them choose a cause to support. Charities that focus on children and animals are usually favorites of young children.

Next, have them pledge a portion of their allowances and future cash gifts to the chosen organization. To keep the discipline going, visit the organization (or website) occasionally for updates and let your children see the good things *their* gifts made happen.

Family wealth planning. As adults we know that having an effective estate plan in place is important. At appropriate ages, which will vary by family, talk to your children about what will happen should you die prematurely.

School-age kids will understand that because you love them, you have selected someone who also loves them to be there to take care of them. Early teens can understand that in addition to arranging for a familiar person to take care of them, you have also made plans to take care of them financially.

If you would like to discuss ways to teach your children or grandchildren about managing finances, or if you would like to have someone outside the family help you do this, please call your advisor.

About the author: Kevin Mikan is head of wealth planning for Contango Capital Advisors and president of affiliated Western National Trust Company. Previously he was head of wealth management for UBS Private Banking and an executive at First Interstate Bank as well as a tax and estate planning consultant for Arthur Andersen and PricewaterhouseCoopers.

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