Investor Insights & Outlook

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Investing in Bond Funds

If you don't want to invest all your assets in the stock market, you may need to consider either cash or bonds for your portfolio. While cash is relatively safe, returns are likely to be less than 1% given the low interest-rate environment. Bond funds are an alternative but most people don't have a good understanding of what to expect. You may want to consider buying a bond fund to give your portfolio stability or help generate income. Unlike individual bonds, bond funds hold a number of fixed-income securities with varying maturities. Therefore, investing in a bond fund provides a diversification benefit. In order to save yourself from making costly mistakes, it helps to thoroughly check up on what a bond fund owns before you buy in. Two basic determinants of bond performance are interest-rate sensitivity and credit quality.

Interest-rate sensitivity is important because an inverse relationship exists between bond prices and yields. If interest rates fall, bond prices rise, and vice versa. The credit quality tells you how risky the bond fund is, which can help determine if the fund fits your risk profile. Consider these factors before you go bond-fund shopping. Just as you wouldn't want to have all of your stocks in one style, you also want to diversify your bond portfolio. A well-rounded bond portfolio should have some exposure to most of the following bond types: Government, mortgage-backed, municipal, corporate, and world bonds. It is important to understand that the right combination of bond funds ultimately depends on your investment goals and risk profile.

Diversification does not ensure a profit or protect against a loss in a declining market.

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Advisor Corner

Bill Roller is experienced in financial planning and investment analysis. He focuses his consulting practice on estate, retirement, and financial planning for businesses and individuals. Bill started BR Capital Inc. in 2003. Before that he worked for a large Wall Street firm for over nine years. He served for seven years as a U.S. Army officer in Infantry and Special Forces (Green Beret) units. Bill is a Chartered Financial Analyst as well as a Certified Financial Planner. He is the VP of the Estate Planning Council of Southwest Washington. He earned a Bachelor of Science degree from the United States Military Academy at West Point in 1982, and a MBA from the Wharton School of Business in 1991. He provides the morning and afternoon market reports and financial commentary for AM 1360 KUIK. A link to Bill's articles and interviews is available at www.brcapitalinc.com/newsletter.

Monthly Market Commentary

The S&P 500 has risen by almost 7% so far in 2012, causing investors to wonder whether the economy is slowly improving or whether this growth was merely the result of the January effect. Global economic news have generally been positive—it included China's slight drop in fourth-quarter GDP (as opposed to a plunge), a relatively quiet Europe, a positive U.S. employment/unemployment report, and the Federal Reserve's promise to extend low rates through 2014. Corporate earnings have so far been a mixed bag, and Morningstar economists believe that even as the U.S. economy continues to recover, earnings may continue to slow, especially for companies with significant exposure to China and Europe.

GDP: Real GDP grew by 2.8% in the fourth quarter, reflecting an overall positive trend in 2011. Consumer goods and inventories (GDP measures production, whether it is sold or simply sitting on a shelf somewhere) led this growth, contributing 1.3% and 1.9%, respectively, while government spending declined by 0.9%, mainly because of cuts in the defense budget. Morningstar economists believe that the 2.8% growth does not represent the new baseline for 2012, because the results were artificially boosted by unexpectedly good weather, the return of more normal auto production, inventory rebuilding, and shifts in retail employment.

Employment: Employment in January grew by an impressive 243,000 jobs, with 257,000 coming from the private sector, while the number of government jobs shrunk by 14,000. Although job growth rose across most sectors (only finance, information services, and government were down), the surprise came mainly from autos and durable goods, which benefited from favorable weather and large jumps in manufacturing and overtime hours, respectively. Retail also came as a surprise, as declines in seasonal hiring were offset by higher department-store and auto-showroom hiring, which boosted overall retail employment into growth territory.

Unemployment: The unemployment rate in January dropped to 8.3% from 8.5%. More important, this reduction came mostly from job growth as opposed to discouraged workers dropping out of the labor force or ceasing to claim benefits. To date, the U.S. economy has regained 41% of the 8.9 million private-sector jobs that were lost during the recession.

Manufacturing: The ISM Manufacturing survey reported better-than-expected numbers, indicating the third consecutive increase in the index and reflecting continued improvement in the auto industry. New durable-goods orders also rose much higher than expected in December, indicating that the manufacturing sector may be picking up steam and growing stronger.

Federal Reserve: The bold decision to keep interest rates low through late 2014 came as a surprise to many, and markets reacted positively to this unexpected news. Morningstar economists believe that continued low interest rates will actually start to pinch savers and hurt the personal income report in a meaningful way. Furthermore, this extended length of time does not lend any sense of urgency to either potential homebuyers or corporations considering large capital expenditures, further suppressing housing and private-sector growth. Given all the global economic uncertainty, there's almost no point in buying anything today when rates are guaranteed to stay low for the foreseeable future.

Despite the good employment news, the overall outlook remains far from optimistic. Rising prices and stagnant incomes put pressure on savings, while the low interest rate environment offers little yield as stocks continue to struggle. Although everybody is hoping for economic growth, the question remains—where will that growth come from?

A Primer on Hedge Funds

Hedge funds are investment vehicles that started to gain recognition in the late 1980s and experienced significant growth in the 1990s. They are "funds" in the sense that their managers pool money from investors and invest it, but their investment strategies are quite different from those of traditional mutual funds. Differences can be found in four major areas: regulation and legal status, investment strategies, performance evaluation, and fees. Mutual funds are strictly regulated by law. They are required to register with the Securities and Exchange Commission (SEC), the United States' official regulatory agency. Mutual funds have to publish a legal document called a prospectus, stating the investment objective of the fund, its strategy, risks, historical performance, fees, expenses and other information. Most mutual funds are widely available for purchase and will accept a large number of investors.

In contrast, hedge funds are not subject to the strict regulations that apply to mutual funds. Hedge funds are not required to register with the SEC, they are not legally required to publicly disclose performance and fee information, and their fees tend to be much larger than those charged by mutual funds. Hedge funds are available only to a limited number of "qualified" (read: "rich") investors, meaning investors with assets in the million-dollar range.

Hedge funds implement what are called alternative investment strategies (as opposed to traditional ones), such as short selling, risk arbitrage, global macro, managed futures, distressed investing, and discretionary trading. We will not describe these strategies in detail here, but the idea is that hedge funds are much more flexible than traditional mutual funds in what their managers do with investments. For example, a traditional investor would buy stock X and hope it goes up in value. If a hedge fund manager had reason to believe stock X would drop in value, he or she would take action in the marketplace accordingly. This is called selling short, a popular hedge fund strategy—not something a regular investor would do.

Hedge funds also differ from mutual funds in the way they measure return. Mutual funds normally look at return relative to the market. For example, you hear that fund X has beaten the market by 4.3% in 2012. Hedge funds tend to look at absolute, as opposed to relative, return: they strive to earn a certain return each year (let's say, 20%), regardless of how the market performs. Hedge fund advocates argue that absolute return is a better performance metric. If a mutual fund manager lost only 6% in a year when the market went down by 12%, he or she would be rewarded for "good" performance. If the fund manager made 20% in a year when the market grew by 30%, that would be qualified as poor performance. Not so with hedge funds. Measuring absolute return prevents this type of error—either you made money or you didn't.

Similar to mutual funds, hedge funds charge an annual management fee calculated as a percentage of total assets. This fee is required regardless of the profitability of the fund. In addition to the management fee (and unlike mutual funds), hedge funds also charge a performance fee. A hedge fund manager can retain a certain percentage of all gains in the fund above a certain rate, which is known as the "hurdle rate." For example, let's say a fund met its hurdle rate of 10% (had a 10% return), and made $1 million on top of that. The manager is allowed to keep his or her incentive fee of (normally) 20%—$200,000.

This information is provided for illustrative purposes only and should not be viewed as a recommendation to buy or sell the type of investment noted above. Please note that hedge funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. In addition, hedge funds are not required to provide periodic pricing or valuation information to investors, involve complex tax structures, often charge high fees, and can be highly illiquid.

Bond Basics

Benefits of investing in bonds: Potential for growth, historically lower risk, diversification and income are some of the benefits of investing in bonds. Generally, bonds have provided investors with growth and historically demonstrated less volatility than stocks. Because economic events that decrease stock prices tend to increase bond prices, and vice versa, adding bonds to a portfolio can provide diversification benefits. Bond investors generally receive income at fixed intervals that can be used to offset cash obligations or increase portfolio liquidity.

Bonds and interest rates: There exists an inverse relationship between bond prices and yields. If interest rates fall, bond prices rise and vice versa. Suppose an investor purchases a 20-year $1,000 bond with a yield of 8% and interest payable annually. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for the original price of $1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower interest or coupon payments (10% – 8% = 2% less per year in interest payments).

Diversification does not ensure a profit or protect against a loss in a declining market. Bonds are subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

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