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Factors In Focus

When It Comes To Bonds, Balance Is Key

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Dr. William Bernstein recently penned an article for the Wall Street Journal, "When Safe Assets Are Risky." He makes the case that bonds should be kept safe to reduce portfolio volatility and enhance liquidity for withdrawals and rebalancing. I've always agreed with this philosophy, so you might not expect me to take issue with the article. I just found it a bit extreme. I think it's a mistake to avoid bond funds, and it certainly is not necessary to restrict fixed income holdings to US Treasury securities and Certificates of Deposit (CDs). I believe a high quality, short-term global bond fund is the best way to target fixed income.

Avoiding Bad Returns In Bad Times

Dr. Bernstein cites the first 10 months of 2008 as a period we should study in an effort to quantify how much risk lies in our fixed income holdings. I agree. The tail end of this period was one of considerable economic and financial market strain and, not coincidentally, would have been close to the most opportune time to rebalance some wealth from bonds and into stocks. Obviously, being forced to sell bonds at temporary losses only to buy stocks at even greater losses dilutes the efficacy of that effort. He concludes that only US Treasuries and CDs passed the safety test.

Table 1: Stock & Bond Returns (1/2008 to 10/2008)

Asset Class	% Total Return
Short-Term (1-5 year) Treasury Ladder	+5.6%
DFA Five-Year Global Bond fund (DFGBX)	+0.9%
Vanguard Short-Term Investment Grade fund (VFSTX)	-5.5%
Vanguard Long-Term Investment Grade fund (VWESX)	-16.4%
Vanguard High-Yield Corporate Bond fund (VWEHX)	-22.6%
Global Stock Asset Class Index	-36.6%

How did a high quality, short-term mutual fund portfolio of global corporate bonds fare from January through October 2008? Table 1 looks at the data. The DFA Five-Year Global Bond fund produced a +0.9% return. Not as good as the +5.6% return on the treasury bond ladder, but not negative either. It turns out, even during this extreme period, that bond losses were mainly in lower-quality corporate bonds—the Vanguard Short and Intermediate-Term Investment Grade funds own a significant share of "lower-tier" investment-grade bonds (A/BBB) and the Vanguard High-Yield Corporate fund owns junk bonds (BB and lower).

What about month-by-month returns? DFA Five-Year Global's worst monthly return over this period was -1.0%. The worst monthly decline for a short-term treasury ladder? -1.0% as well. So high-quality *corporate* bonds held up just fine during the stiffest test for bonds in a long time. Maybe they didn't surge in price, but there were no dramatic declines either.

Looking Longer Term

For long-term investors, though, 10 months in 2008 should not be the only consideration. We're investing for decades, not days. And over time, small differences in return can add up to significantly greater wealth—in stocks *and* in bonds. The inception of the DFA Five-Year Global fund was December 1990, and through September of this year, it returned +5.6% per year (+6.0% gross of fees). A 1-5 year treasury ladder? +4.9%. That's 0.7% per year higher net returns including a period in the 1990s where the DFA fund had an expense ratio almost double its current rate. And we're ignoring any costs or cash drag associated with the treasury ladder, which is unrealistic in practice.

Investors should ask themselves the question—is a few percentage points of higher potential return during the next bear market really important enough to sacrifice almost 1% per year of higher potential returns and the added complexity of an individual bond ladder compared to a short-term bond mutual fund? I certainly don't think so.

Forget the Free Toaster, Too

What about CDs? Setting aside the annoyance of shuffling your savings all across the country in search of the bank or credit union with the best teaser rates (not to mention the best give aways), you can throw accessibility out the window—most CDs charge up to 6 months of interest if you have to redeem them early. And given that portfolio rebalancing often needs to take place at least annually, you're likely giving up much of any yield advantage in early withdrawal penalties if you don't stagger your CD maturities.

And with a CD ladder, you naturally sacrifice yield. By how much? This website provides us the absolute best rates in the entire country on CDs about 5 years ago in April 2010. Locking up money for 5 years, you were able to get a yield of +3.4%. The return since April 2010 on the DFA Five-Year Global fund? +3.1%.

What if you held held a CD ladder consisting of a 1-year CD, a 2-year CD and the 5-year CD to address the liquidity and early-withdrawal issues? Even tracking down the three highest yielding CDs (at three different institutions), your weighted average yield was +2.5%, over 0.5% per year less than simply using the high quality, short-term DFA Five-Year Global Bond fund. And even this ignores the reinvestment risk as you were forced to roll maturing CDs into new certificates over the last five years at lower and lower rates to maintain your ladder.

What About Bond Fund Risk?

Finally, no discussion of bond mutual funds would be complete without covering the irrational fear many investors have—significant principal losses if interest rates rise.

The key with bonds is balance. As long as you stick with short maturities (5 years or less) and diversify across high-quality corporate bonds in multiple countries, the risk is minimal.

Table 2 looks at the evidence. Since the first full year of operation for the DFA Five-Year Global Bond in 1991, 24% of rolling 12-month periods saw long-term interest rates rise.* The fund's average annual return during these periods was +3.4%, even better than the +3.2% return on 1-month treasury bills and much better than the -3.0% average loss on long-term treasury bonds. More importantly, if you own stocks as part of a balanced portfolio, you probably didn't even notice rising interest rates—over this period, the S&P 500 averaged +17.8% during all 12-month periods when rates ticked higher, a globally diversified index did even better, +21.1%. Clearly, *portfolio* balance works too.

Stop Fussing With Your Fixed Income

The reality is, investors shouldn't overcomplicate their bonds (or stocks, for that matter). Holding individual treasury issues in your brokerage account or at Treasury Direct, CDs at the latest asset-chasing bank, and munis through your local bank or broker who are licking their chops to shave a hidden spread off your principal (and do it again when the muni bond is called early and you have to reinvest in another bond from their inventory) is totally unnecessary. A high quality, short-term bond mutual fund is sufficient for the purposes of reducing stock asset class volatility and has been more than liquid enough to provide a source of withdrawals during even the most severe market declines.

**rising long-term interest rates defined as a negative 12-month return on the Fama/French "Term" Factor*

Table 2: Rolling 12-Month Returns (1991 though 2014)

Asset Class	Average Annual Return When Interest Rates Rose
One-Month Treasury Bills	+3.2%
Short-Term (1-5 year) Treasury Ladder	+2.3%
DFA Five-Year Global Bond fund	+3.4%
Long-Term (20-year) Treasury Index	-3.0%
S&P 500 Index	+17.8%
Global Stock Asset Class Index	+21.1%

Source of data: DFA Returns 2.0

One-Month Treasury Bills = Ibbotson Treasury Bill Index; *Short-Term Treasury Ladder* = Barclays 1-5YR Treasury Index; *DFA Five-Year Global Bond fund* = DFGBX; *Long-Term Treasury Index* = Barclays Long-Term Treasury Index; *Global Stock Asset Class Index* = 21% S&P 500 Index, 21% DFA US Large Value Index, 28% DFA US Small Value Index, 18% MSCI EAFE Value Index (gross divs.), 12% DFA Int'l Small Value Index, rebalanced annually.

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