THE RUDD COMMENTARY

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We are pleased to publish this edition of *The Rudd Commentary*, which is a periodic publication designed to bring you a professional opinion on the current investment environment and some developing trends. Please feel free to forward *The Rudd Commentary* to family, friends, and business associates who might find this information valuable.

BONDS WILL BE BONDS

As Jennifer and I have been blessed over the years with five healthy children, we have been students of God's very imaginative and humerous training program, "parenting for dummies". In this challenging, physical, and very humbling program, we have learned some of life's basic truths which all seem so simple now, but eluded us greatly in the beginning. Things such as "someone is ALWAYS listening to our conversation", or "sixteen year old girls ALL suffer from multiple personality disorder", as well as "pain is the universal language that ALL children understand and quickly respond too",and the most obvious to me now, "there are BIG differences between boys and girls". It is the latter that I wish to briefly discuss.

It should seem very obvious that boys and girls are different. After all boys and girls clearly differ in size, physical strength, anatomy, and the ability to carry and birth a child, but are also very different in the way they process information, communicate, deal with stress and handle their emotions. It is embarrassing that it took me five children to discover something so fundamental and straightforward, but given the inconsistent message of gender "sameness" communicated by public schools, the media, and our government, I can now better understand why so many parents seem confused about these differences and their own very different roles as mother and father.

It may seem odd to compare this experience to investing; however, I have recently noticed that many investors have been similarly troubled as they try to understand important differences among the investments in their portfolio; particularly between stocks and bonds. Rising media attention about the impending doom in the bond market is currently creating angst among bond investors. Every day I hear the media reporters implying that investors stand to experience stock market like losses in their bond investments if they continue to hold onto their positions in an era of rising interest rates. This has prompted many of our clients to call with the question "should we sell all our bonds?"

In order to offer clarity and help investors filter through the hype and ignorance being reported in the media, let's take a look at what makes bonds different from stocks, identify the risks bond holders currently face in the markets, and evaluate if investors should sell all their bonds as many media personalities currently suggest.

GENTLEMEN PREFER BONDS

Bonds and stocks are the two most fundamental forms of investments used in portfolios today. They both offer the opportunity for investors to earn a return through income and/or capital gains and can be bought or sold relatively easily any business day. They are both subject to varying degrees of risks and experience daily price fluctuations. But, this is where the similarities end.

Much like boys and girls, stocks and bonds respond very differently to variables in their respective environments. This doesn't mean one is better than the other; it just means they are different and are suited to accomplish different objectives.

The most important difference between bonds and stocks is the nature of the claim or ownership that these very different securities represent. For example, a bondholder of XYZ Company has a claim against the net ASSETS (balance sheet) of XYZ Company. This could be all assets, a specific asset, or even an unsecured claim that is subordinate to other investors. In strict contrast, a stockholder of XYZ Company has a claim against the PROFITS of the company in some form. These profits can be distributed through the payment of dividends to investors or reinvested back into to the business with the hope of some future, and higher distribution. In its simplest form, bondholders are loaning money to XYZ Company and are concerned with receiving their interest payments and a return of their loan principle at maturity. On the other hand, stockholders want the company to increase its profits, which could encourage very different (or even opposing) actions from the company.

So are stocks or bonds riskier? Well, it depends on what risk you are talking about. Almost all investors I speak to are concerned with "getting their money back", specifically the principle they invested as opposed to the many other kinds of risks out there. If this is the case, a bond is designed to do just that. Most bonds are sold with a rate and a date. This means we know the interest rate we will earn on the investment and we know when we will get our money back if held to maturity. With this information, we can calculate exactly what we will earn on this investment if two conditions are met: 1. we hold it to maturity 2. the interest and principle payments are made as guaranteed by the issuing company. As we discussed earlier, if the issuing company fails to meet its commitments, bondholders have recourse through a claim on the company's net assets.

These characteristics of bonds make them fundamentally different from other types of investments. For example, in the event of a bankruptcy imagine a long line of investors waiting at the front door of XYZ Company the morning after. If we arrange these investors in order of who is most likely to get some of their money back, employees and general creditors are somewhere close to the front, bondholders are generally in the middle, and stockholders would have better luck ice fishing in Texas.

HURRY UP AND WAIT

It seems very obvious that interest rates are at or near their lows and will eventually move higher. This is the basis for much of the negativity surrounding bonds as a current investment opportunity. After all, if we know that bonds perform poorly when interest rates rise, why would we own them at all? Shouldn't we just sell them when they are "high" and move our money to cash or stocks? To answer these questions, let’s take a look at what happened to bond returns during the last period of substantial rate hikes by the Federal Reserve.

From 1977 through 1981, the Federal Reserve Bank raised short term interest rates from 6% to near 20% in an effort to control growing inflation[1]. During this period, investors saw intermediate government bonds decline five years in a row from 1977 to 1981 by -5.15%, -4.49%, -5.07, -6.81%, and -4.55% respectively[2]. While this decline may seem dramatic, remember our previous discussion on the how bonds differ from stocks. Would it surprise you to learn that when the income from these bonds is included, the corresponding total returns for the same periods were +1.41%, +3.49%, +4.09%, +3.91%, and +9.45% respectively[2]? Although bondholders did see their statement values drop in the selloff, those that held their intermediate government bonds received their timely interest payments and the full face value of their bonds back at maturity. It wasn't just good luck. That’s what makes bonds so attractive to conservative investors and an effective compliment to a portfolio of stocks.

CLEANING MY GUN

Having four beautiful girls, I have begun to empathize with the fathers I encountered when I was in high school. While this is a difficult time in my training as a father, I realize that if I can stay on the balls of my feet, I have a tremendous opportunity to positively impact each of my daughter’s long-term happiness by not so subtlety influencing which boys are allowed to court them. Much like the current prospects in the bond market, I have found the outlook for potential suitors less than attractive. However, there will be opportunities if I stay alert and quickly disable the landmines.

The key to making any investment be it bonds, real estate, or future spouses, boils down to knowing the reality of yourself and the market, being patient, and finding what you want. Yes, most bond mutual funds will underperform other asset classes in a rising interest rate environment. But, a properly managed asset allocation strategy should offer investors the ability to identify the problem areas to avoid and be ready for the opportunities that will come along. Recently, investors have been pulling billions out of municipal bond mutual funds[3]. This, in-turn has led to some very attractive prices (higher yields) on many high quality municipal bonds. I expect these moments of panic to continue and give way to more opportunities in various areas of the bond market. Luck will favor the prepared.

NOTHING MORE DECEPTIVE

As I continue in my profession, I seem to come up with simpler and simpler explanations for many investing questions that at the beginning of my career would have prompted me to answer with longer and more esoteric explanations. Hopefully, my clients find this simpler approach more helpful instead of inferring a lack of interest from me in these topics.

Like our societies growing fascination with behavioral comparisons between boys and girls, much of the recent media comparisons of bonds and stocks are sensational and in some cases just plain silly; especially when placed in their true natural or economic context. Yes, we all realize the market value of bonds will decline when interest rates rise, but most will make their interest and principal payments as scheduled. At the end of the day bonds will perform differently than stocks because they are bonds, equal in dignity, but not the same.

Invest Long and Prosper,

Josh Rudd

[1] Bureau of Labor Statistics (BLS)
[2] 2013 Ibbotson SBBI Classic Yearbook
[3] 4Q J.P. Morgan "Guide to the Markets"