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It's Just Math

by Kamyar Kashfi

The bond market experienced one of the largest declines in a short period of time in recent memory from the beginning of May through the middle of July. Investors speculated that the Federal Reserve was ready to reduce stimulus measures which have been attributed to low rates and strong bond prices. The benchmark 10 year treasury yield went from a low of 1.614% on May 1st to 2.601% on July 12th.[1] A full 100 basis point move, which as a percentage is greater than a 60% increase, is rather significant. Bonds prices with a duration of 10, decreased about 10% in just two months. These aren't the types of swings many people expect in their "conservative" bonds. In last month's newsletter, I discussed the new crisis du jour, "Fed Tapering". More importantly, I discussed how this situation was nothing more than a manageable event when taken within the context of a properly diversified and periodically rebalanced account.[2]

First, what is duration? A simple definition of duration is that it is a measure of bond price sensitivity relative to changes in interest rates.[3] A bond with a duration of 10 would be expected to decline 10% for every 1% increase in rates. Therefore, a 100 basis point move from May 1st through July 12th would be expected to incur a decline in fixed income investments, with a duration of 10, of about 10%. Over the past year, as an advisor I have been working to reduce bond duration in accounts by shortening maturities, increasing coupons or reducing my portfolio allocations to bonds. In addition, I have increased exposure to equities and pursued alternative methods of collecting income such as dividend paying stocks. Stocks and bonds each carry a variety of risks and periodic rebalancing on each side of the ledger also occurs. When bonds drop the media focuses on the drop in bonds and when stocks drop the media focuses on the drop in stocks. You hear much less about the good things that happen and almost never hear about the cumulative effect each has on a balanced portfolio.

Let's do some math. If I have rebalanced a portfolio to favor equities over bonds and reduced my duration to 10, what happened after the latest "Fed Tapering" crisis du jour? We'll use a moderate 60/40 portfolio which has 60% stocks and 40% bonds. From May 1st through July 12th I would expect a 10% decrease in the value of my bonds. This decrease is not a loss, however, because I can continue to hold my bonds and collect income. During the same time, the Wilshire 5000 Total Market Index (an index we'll use to simulate a broad exposure to small, mid and large cap stocks) gained 6.4%.[4] Every $60 of equities would be worth $63.84 and every $40 dollars of bonds would be worth about $36 for a total of $99.84. In other words, for every $100 invested, my equities and bonds almost perfectly balanced each other out. There was no "crisis". It's just math.

Managing an account and expectations is obviously more difficult than this example would suggest but one can see that diversification and rebalancing with the help of a professional can and does have its benefits. Investors have different objectives and risk tolerances which lead to different allocations and varying results in changing investment landscapes. The moral of this story is that results can be managed through proper diversification and periodic rebalancing. As investors we do not need to fear the latest crisis and can maintain our view of long term results.

Let's review your portfolio! Take a proactive approach and plan ahead!

1.http://www.marketwatch.com/investing/bond/TMUBMUSD10Y?countrycode=BX
2.http://www.stockcross.com/docs/newsletters/newsletter_june2013_web.pdf?sfvrsn=2
3.http://www.investopedia.com/university/advancedbond/advancedbond5.asp
4.http://www.bloomberg.com/quote/WFIVX:US

Broker Spotlight

Kamyar Kashfi, CFS
Senior Vice President - Investments
800.549.2185
kamyar.kashfi@StockCross.com