CHARTING THE COURSE

Special Series of Briefs About Beacon's Client Services

Our Case for Using Bond MUTUAL FUNDS vs. Individual Securities:

More Bang For Your Bonds

Bonds are often generically termed "fixed income" to describe the specific dollar income investors receive from them. Compared to stocks that usually have uncertain return outcomes—especially in the short run—bond returns generally are more reliable. Each of **Beacon's** clients have unique financial goals and tolerance for risk, and bonds as part of a balanced portfolio offer a number of significant portfolio benefits. They tend to preserve capital because, in general, they are a lower-risk asset class than stocks. Bonds hedge a portfolio against the volatility of stocks and the fluctuations in the economy—a kind of "anchor to windward" to borrow a nautical term. Finally, the yield of bonds can provide a steady earning stream.

When you buy a bond, you lend money to a government, municipality, corporation or some other type of issuer for a specified rate of interest during the bond's life, and repayment of the bond's face value (your principal) when the bond matures. These issuers pay back their debt to you as a regular stream of income. Over time the price of your bond in the marketplace can rise or fall if the issuer's credit improves, or if interest rates change. **Beacon** believes bonds play a key role in your balanced, global portfolio (see our white paper Balanced, Global Investing Using Mutual Funds). The challenge—which requires considerable investment expertise and experience—is to find just the *right* bonds for you, at a price you want to pay, a risk level you can live with and with the lowest possible tax burden.

Continuing our case for using bond MUTUAL FUNDS, let's consider when investing in bonds you can either adopt a passive buy-and-hold strategy, or your can use active management. The buy-and-hold to maturity has a certain appeal in terms of simplicity. Barring a default by the issuer you can feel secure knowing you'll receive regular, fixed interest payments and get the bond's full face value at maturity. Some take buy-and-hold a step further and buy a "laddered" portfolio of quality bonds whose maturity dates are alternately lengthened like a "ladder". With a "ladder", you redeem the bonds that mature each near period, replacing them with new bonds on another rung of the "ladder." The passive "ladder" approach is a generally prudent and relatively reliable one for the individual investor. If you stick with high-quality bonds you can be pretty confident you'll get your principal back as the bonds mature, and you reduce transaction costs because you redeem the bonds rather than sell them. In **Beacon's** opinion the complexities and costs of retail trading in bonds makes it a near imperative to use a buy-and-hold "ladder" approach. The sheer size and scope of the U.S. bond market is impressive (extend that to the global bond market and it's even more so). For example, just the U.S. municipal bond market has over 50,000 different government or quasi-governmental entities issuing debt that is currently near $3.0 trillion. New bond issues enter the municipal market every week. There's also the secondary market, largely the domain of bond professionals, who actively trade to get the best buy-and-sell prices. And that's just the municipal market. The US federal government's Treasury Department issues may types of bonds as do various government agencies. The US corporate bond market is vast, and individual corporations often issue different types of bonds from the same company! Then there is the collateralized-mortgage bond market, and the asset-backed bond market and on and on.

Beacon has a better strategy than buy-and-hold "laddering"—one that is equally safe, but that generates a higher return. We believe the best bond values are found in the secondary markets (instead of new issues). Furthermore, in most markets you can sell bonds before they mature at a higher price than cost and generate a higher return than a simple "ladder" approach of waiting until maturity. To do this we turn to skilled bond professionals that practice this active management in bond MUTUAL FUNDS.

Bond MUTUAL FUND managers have access to a wealth of market and security-specific data out of the reach of most individual investors. Bond MUTUAL FUNDS also provide superior access to a wide range of securities at competitive pricing. Individual investors often rely on bond ratings provide by one or more of a handful of credit rating agencies registered with the SEC as "Nationally Recognized Statistical Rating Organizations" (NRSROs). While it is beyond the scope of this piece to expand on NRSROs, there have been numerous instances in which these entities utterly failed to accurately access investment risk (e.g. the mortgage ratings failure that contributed to the 2008 "Great Recession" et al). In **Beacon's** opinion there are skilled bond professionals that have research expertise to buy and sell individual bonds before ratings changes are made by the agency analysts, providing added-value to active management.

Beacon contends that the bond market, like the stock market, is inefficient. Bonds often sell for more or less than they're worth—not only because investors overreact to transitory events, but because today's complex securities contain risks and benefits that are hard to analyze. To achieve our goal of a higher risk-adjusted return than that of buy-and-hold individual bonds, our MUTUAL FUND managers go beyond the rating agencies and constantly scour the ever-shifting markets to find values. Professional bond research involves financial items or terms uncommon or unfamiliar to most individual investors; Macaulay duration, immunization, yield curve term structure, bullet-structure v. barbell-structure v. concentrated-structure, convexity, call provisions, collateral securitization provisions, indentures, etc.—just to name a few.

In summary, **Beacon** practices balanced, global investing. We most often use "active" investment managers that make investment decisions based on extensive research, in contrast with "passive" strategies. We believe asset prices (stocks, bonds, etc.) can stray from their fundamental value in part because many investors buy and sell based on emotions like greed, fear and panic, producing short-term volatility. We believe that investing for the long term, based on thorough fundamental research and valuation discipline, is appropriate for any market environment. Specific to bonds, the tenets of our approach are:

⇒ **RESEARCH IS ESSENTIAL.** **Beacon** discovers MUTUAL FUND managers with a dedicated research staff consisting of analysts, economists, portfolio managers and traders, all with deep-fixed income experience. We want managers that act solely as our clients' agent, neither adding to the prices of bonds bought for accounts nor retaining any of the proceeds of their sales.

⇒ **TOTAL RETURN IS THE OBJECTIVE.** Too many individual investors make bond purchase decisions on a single or twin factor: yield and rating. It's not just yield that determines what you earn in bonds; as in stocks, yield can be more than offset by price declines. A superior approach seeks total return, yield plus the change in principal value.

⇒ **PROFESSIONAL MANAGEMENT (VIA MUTUAL FUNDS) BEATS BUYING-AND-HOLDING INDIVIDUAL BONDS.** Professionally managed MUTUAL FUNDS are able to buy at far better prices, access the secondary market as well as new issues, monitor the differences between tax-exempt (municipal) and taxable yields, seize new opportunities, seek out and quantify emerging risks and own a wider variety of bonds than is feasible for most individual investors on their own.

BEACON Financial Advisors Ltd.