

against the grain

Finding opportunity in the bond market

By Christopher M. Lamb, CIMA

We've all experienced the bad news and witnessed the panic associated with the stock and bond markets. The economic situation has been bleak, and the short-term outlook isn't all together that great. Is there a silver lining in this for opportunistic investors? Where are the values for those investors who have little appetite for stocks?

The corporate bond market has been hit especially hard through this recession. With corporate profitability being called into question, well-run Fortune 500 companies found their bonds priced to yield 30 to 50% more than their original coupon amidst a fast a fierce declining interest rate environment. When compared to Treasury obligations, they are providing an excellent opportunity to provide high yields to investors willing to take the plunge.

The Treasury market may well be in a bubble, meaning their prices have advanced so rapidly, that they will soon come back to reality. Without much doubt, with short-term Treasury bills priced to yield a paltry .004% on an annual basis, there is little reason to buy treasuries at all. Where is the incentive? Simply put, there isn't any.

Taking look at the corporate bond market can yield some interesting opportunities for investors. While some

people have considered abandoning equities completely, they shouldn't overlook the concept of owning corporate bonds. Whether it is purchasing a stake in a convertible bond (one that can be converted into the common stock of an issuer) or a high yield bond (one that has little to no collateral backing the issue), or a plain vanilla high-grade corporate issue, there are some great values within today's market. As panic subsides, and the credit markets begin to thaw, prices will regain their footing and begin to trade based on their supply and demand rather than the fear in the marketplace at the moment.

If there is one thing to rely upon, it is the ability of a diversified corporate bond portfolio to produce an even supply of income for an investor. At this moment, however, there can be a second component to the return mechanism for corporate bonds investors - appreciation. As fear grips the market, investors abandon their appetite for risk in favor of safer investments. More people willing to sell compared to those willing to buy can lead to lower prices and higher yields for corporate bond investors. For those investors waiting on the sidelines, understand that this type of phenomenon won't last forever.

Corporate bond prices are low, and government bond prices are very high.

Even since the last portion of 2008, we have seen nice rallies in both the corporate and municipal markets. As things begin to normalize, it won't be uncommon (in the short-term) to potentially see returns for corporate, municipal and high yield fixed income markets to generate returns comparable to the long-term returns of the equity markets. It's not sustainable, but getting back to a normal market means substantial rallies in most segments of the fixed income markets. We would say, however, that government securities will be the exception to this thought, since their prices are out of reality at the moment.

It's been said that the best returns for equity investors are made during the bottom formations in bear markets. This will most likely hold true for fixed income investments as well.

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Building a bond portfolio during normal market conditions can be a good way to diversify while reducing risk. Building a bond portfolio during opportunistic times like these could now prove to be a 'growth proposition' for investors in the short-term.

Seeing the light
Presque Isle lighthouse in Presque Isle Michigan. Standing watch since 1840.