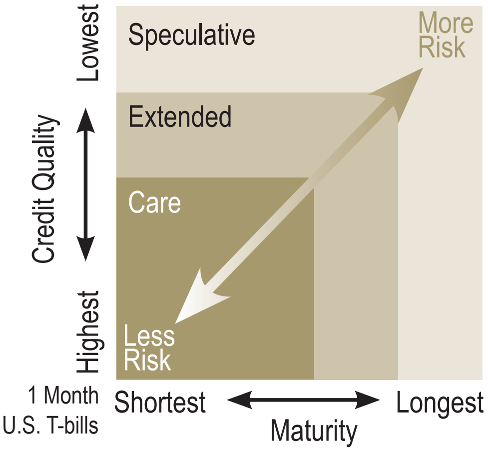
Asset Class Investing **FYI**

Why Stay Conservative In Fixed Income?

We believe investing revolves around the intertwined concepts of risk and return. The more risk you are willing to take, the more return you should expect.

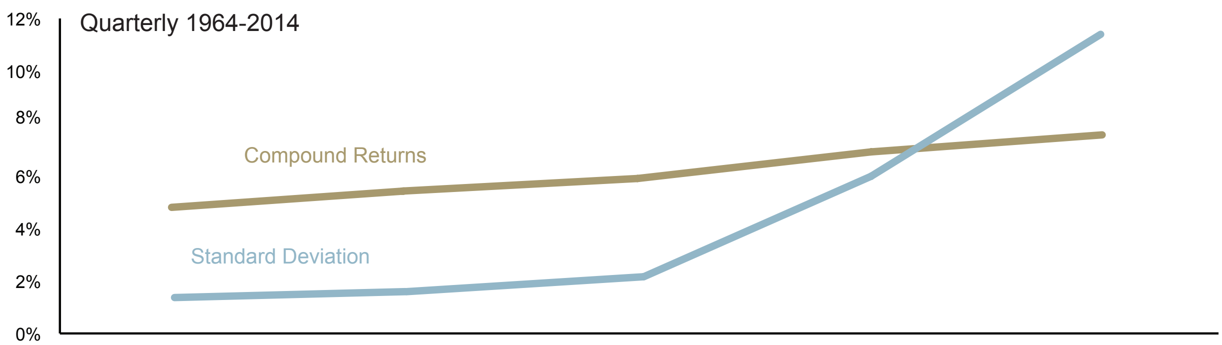
When investing in fixed income, two main concerns drive the risk return tradeoff: maturity and credit. As the maturity of a bond increases, its interest rate risk increases and so should its return. When the credit quality of a bond declines, its default risk increases and so should its expected return. In practice however, the relationship between risk and return for bonds has not been linear.



Lower Volatility

Shorter Maturities

In essence, investing in bonds is simply lending a company your money for a specific period in return for them making periodic interest payments to you and then returning your principal at some predetermined "maturity date." For longer maturity dates, investors demand a higher coupon rate because of the increased chance that the company could go bankrupt before it can pay back the principal. Longer maturities do have increased annual return expectations, but the additional return comes at the steep price of much higher volatility.



Maturity	1 Month US Treasury Bills	6 Month US Treasury Bills	1 Year US Treasury Notes	5 Year US Treasury Notes	Long-Term US Treasury Bonds
Compound Returns (%)	5.01	5.72	5.92	6.97	7.54
Standard Deviation (%)	1.54	1.88	2.39	6.05	11.42

Source: DFA Returns. One-Month US Treasury Bills, Five-Year US Treasury Notes, and Twenty-Year (Long-Term) US Government Bonds provided by Ibbotson Associates. Six-Month US Treasury Bills provided by CRSP (1964-1977) and B of A Merrill Lynch (1978-present). One-Year US Treasury Notes provided by CRSP (1964-May 1991) and B of A Merrill Lynch (June 1991-present). Ibbotson data © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield). Assumes reinvestment of dividends. Past performance is not indicative of future results. Standard deviation annualized from quarterly data. Standard deviation is a statistical measurement of how far the return of a security (or index) moves above or below its average value. The greater the standard deviation, the riskier an investment is considered to be.

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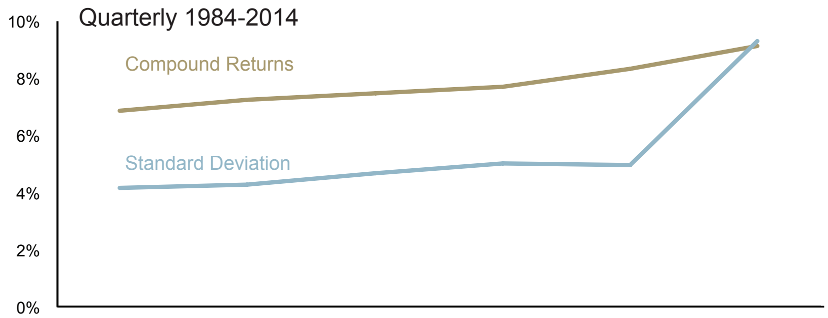
Higher Quality

Historical evidence shows us that investors have not been adequately compensated for extending the credit quality of their bonds below investment grade (BBB). High yield bonds do have a higher average yield, but often exhibit extreme periods of inflation, and the risk of default and loss of principal is significantly higher than investment grade companies.



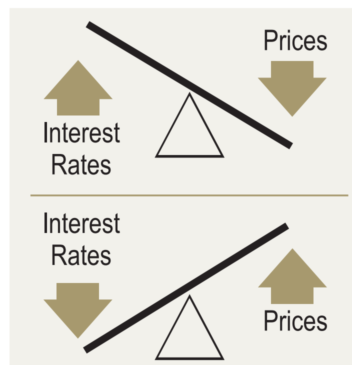
Quality	Government	AAA	AA	A	BBB	High Yield
Compound Returns (%)	6.71	7.09	7.33	7.56	8.18	8.88
Standard Deviation (%)	4.08	4.22	4.61	4.95	4.89	9.20

Source: Morningstar Direct. Government rating is BarCapUS Government Intermediate Index, AAA rating is BarCap US Intermediate Credit Aaa Index. AA rating is BarCapUS Intermediate Credit Aa Index. A rating is BarCap US Intermediate Credit A Index. BBB rating is BarCap US Intermediate Credit BBB Index. High Yield rating is BarCap US High Yield Intermediate Index. Indices are not available for direct investment. Assumes reinvestment of dividends. Past performance is not indicative of future results. Standard deviation annualized from quarterly data. Standard deviation is a statistical measurement of how far the return of a security (or index) moves above or below its average value. The greater the standard deviation, the riskier an investment is considered to be.

Inflation and Interest Rate Protection

Much of the volatility seen in bonds comes from interest rate risk. As rates go up bond prices move down, and investors would rather buy freshly issued bonds with higher coupons. Interest rate risk can have a large impact on the prices of the bonds held. The longer the average maturity of the bonds held, the greater impact a change in interest rates will have. In a rising rate environment, longer-term bonds will decrease faster than short-term bonds and vice versa.

Rising inflation will affect bond prices because the value of your future coupon and maturity payments will be worth less. Short-term bonds may act as a good hedge against inflation because your bonds will be maturing quickly and principal proceeds will be returned, with the potential ability to be reinvested at higher rates.



Wealth Preservation

We believe investors whose goal is wealth preservation should try to strike a balance between income received and volatility realized. An allocation to highly liquid, conservative bonds can help reduce the downside risk of ongoing or one-time withdrawals.

Most investors want to maximize their returns for a given level of risk. As shown below, higher yields are available in bonds by taking maturity and credit risk, but at the cost of increased volatility. This is why we believe that most investors are better compensated by allocating their risk budget towards stocks and staying more conservative in bonds. We believe a lower risk profile in bonds allows investors to take slightly more risk with their stock portfolio, while maintaining liquidity.