

Stocks or Bonds?

For the last year or so, many of the "pundits" have been recommending that investors switch from stocks to bonds. Quite naturally this has triggered many of you to call and see if we agree. While our answer differs somewhat with each of you, generally speaking, we feel that this is not a good time to make this transfer.

Historically (since 1925) stocks have produced total returns about twice that of bonds. Knowing this, generally the only reason to buy bonds is for safety. So, just how safe & stable are bonds? First, as a review, while bonds do have a maturity date at which the investor is assured the full value of the bond, you should remember that in the interim, the principal value of a bond can and does fluctuate. A major factor that causes bonds to rise and fall in value is the current interest rate available with other investment alternatives such as Certificates of deposit. Frequently, as interest rates fall, bonds increase in value and as interest rates rise, bonds fall in value. Another major factor affecting the market price of bonds is the length of their maturity. Bonds with longer maturity dates (15 to 30 years) will fluctuate more than bonds with shorter maturities. You probably remember the very high interest rates of the late 70's and early 80's. Since that time, interest rates have been declining. During the last 20 or so years, there have been short periods when interest rates have risen temporarily but the big picture shows a long gradual decline to our current rate.

Recently, bonds, which have risen over the last 20 or so years (as interest rates have declined) have started to decline. Many investors who switched from stocks to bonds recently to avoid the risk of stock market fluctuation, must now feel that they have jumped from the pan to the fire. The Wall Street Journal recently reported that since June 13th (the recent high of bond prices), Treasury yields have risen faster than at any time since 1987. I remember 1987...do you remember 1987? This increase has translated into a loss of nearly 10% for investors holding the 10 year treasury bond and nearly 15% for those investors holding the 30 year treasury bonds. To put this into perspective, the Dow Jones Industrial average would have to fall about 1400 points in the next 60 or so days to equal this decline in the value of bonds. So much for the safety and security of bonds. James Bianco, head of the research firm Bianco Research, was quoted in the Wall Street Journal as saying "Bond investors are looking for the license plate number on the truck that hit them". Of course, as I mentioned earlier, bonds have a maturity date and if held to that date, investors will receive the full value of the bonds that they own. But in the meantime, just as with stocks, the ride can be unsettling. We think it's important for you to realize that bonds are not always a safe, secure place to invest.

One of the reasons we feel this is not a good time to switch from stocks to bonds is that with short term interest rates currently near or below 1%, there seems to be limited potential for them to decline significantly from this point. As you already know, we do not have a crystal ball, but usually as the economy slows, the Federal Reserve (the folks who control interest rates & the money supply) will lower interest rates to stimulate the economy. As the economy improves the Federal Reserve will likely raise interest rates to keep inflation in check. At Sycamore, we think the economy is improving from our recent recession. If we are correct, interest rates could start to rise. If that happens, bond values, especially long term bonds, will likely fall.

One additional reason not to switch to bonds now. Over the last three years the stock market has suffered one of its most severe declines since the Great Depression. Thinking long term, it seems to us that bonds, on a historical basis, are relatively high and stocks are more reasonably priced. That would translate roughly into buy stocks and sell bonds, but since no one knows for sure, we feel that the best course for most investors is to stay with the allocation of stocks and bonds that has worked well for you in the past.

Thanks for your business!

For more detailed information regarding your individual situation, feel free to give us a call or simply return this note with your request.