The History of Bonds

Bond-like financial instruments have a long history. Denizens of Venice in the 14th century could purchase and trade government securities which paid the owner an endless annuity at a set rate. In 1794 Britain consolidated all of its long-term obligations into a security known as "consols" which pay a dividend to the owner, also without any expiration date. These consols are still traded.

Unexpected losses in these securities also have a long history. For instance, the consols were issued at a time when currency was backed by gold, and inflation was not a consideration. When currencies were unshackled from gold, interest rates began to rise. The holders of these old consols, locked into a low rate of return, saw dramatic erosion in the value of their securities. During a period in the 1920s when Germany suffered hyper-inflation, the value of German-based bonds lost virtually 100% of their value within a period of months.

The Moral: Be aware that investment climates change and what were once great investments can turn into liabilities.

The Eisenhower Recession – Multiple-Year Bond Losses

The years 1955-1959 were not kind to bond holders. Holders of long-term government bonds lost money in four of the five years, with annual returns of -1.3%, -5.6%, 7.5%, -6.1% and -2.3%. Intermediate Treasuries fared better, but also had losses for four of the five years. Over the same period, holders of long-term corporate bonds experienced losses of -6.8% in 1956, -2.2% in 1958 and -1.0% in 1959.

Starting from 10-Year Treasury rates below 3%, a steady rise in interest rates tried the patience of bond holders from 1955-1959:

<table>
<thead>
<tr>
<th>Total Returns</th>
<th>Long-Term Govt Bonds</th>
<th>Long-Term Corporate Bonds</th>
<th>Intermediate Treasuries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955</td>
<td>-1.3%</td>
<td>0.5%</td>
<td>-0.7%</td>
</tr>
<tr>
<td>1956</td>
<td>-5.6%</td>
<td>-6.8%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>1957</td>
<td>7.5%</td>
<td>8.7%</td>
<td>7.8%</td>
</tr>
<tr>
<td>1958</td>
<td>-6.1%</td>
<td>-2.2%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>1959</td>
<td>-2.3%</td>
<td>-1.0%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>1955-59</td>
<td>-8.11%</td>
<td>-1.42%</td>
<td>4.81%</td>
</tr>
</tbody>
</table>

The problem for bond investors was steadily rising rates. The yield on the 10-Year Treasury started this period below 3%, and dipped below 3% again in 1958. On January 1, 1955 the yield on the 10-Year was 2.61%. By January 1, 1960 the yield had risen to 4.72%, an increase of 2.11%. Of course this was before the invention of derivatives and the development of a global market, which give modern markets higher potential volatility.

The Moral: Losses in the bond market can be multi-year affairs, but can be tempered by holding bonds with shorter maturities.

1969 – The Worst Year Ever for Long-Term Bonds

Rampant inflation and rising interest rates were the story in the latter half of 1968 and through 1969, as the Viet Nam war waged and race riots marred urban centers. Salomon Brothers estimated at this time that long-term bonds lost 20-25% of their value over this period and many government issuers withdrew proposed muni-bond offerings as the market demanded excessive rates. By the end of 1969, investment grade corporate bonds were being issued with coupons over 9%. As Time Magazine reported on December 4, 1969, the value of long-term Treasuries “dropped from $1,000 to $714” and “some experts wonder if investors keep expecting endless inflation, whether these fixed-interest bond and mortgage markets can survive in their present form.”

The Moral: While long-term bonds were being crushed, intermediate-term government bonds lost only -0.7% in 1969. Risk-conscious investors should not compromise interest-rate risk in the pursuit of additional yield.
In late 1994 Fortune Magazine declared the loss of $1 trillion in assets a “bond market massacre.” This bond market disaster was sparked by the Federal Reserve raising short-term rates in February of that year and was exasperated by the use of derivatives and leverage. Over the course of the year, the Fed raised short-term rates from 3.00% to 4.25%. This was magnified in longer term bonds, particularly in long-term Treasuries, where investors had been seeking higher yields. Long-term rates jumped higher, created significant losses for managers who had taken the opposite positions. Just as we saw in 2008, some hedge funds imploded and the proprietary trading desks at some investment banks suffered deep losses.

As the Fortune story detailed, “Most bond fund managers aren’t supposed to make big bets… About the only thing a fund manager can do if he is convinced rates are headed up is to shorten the maturity of the portfolio. But most managers failed to do that this year.”

Business Week put it this way on March 21, 1994: “The precipitous fall has little to do with inflation – and everything to do with the sudden bursting of a huge speculative bubble in the global fixed-income markets.”

The Moral: It is hard to judge the depth and nature of speculation and leverage until the damage has been wrought. Conservative duration positioning and focus on quality issuance are the best defenses against rising rates and a bear market in bonds. Also, it is prudent to understand all of your holdings, especially if they involve leverage or exotic securities.

2008 – A Year of Surprises
Plain Vanilla Funds Turn Spicy
Looking back at the bond market for the year 2008, it appears to be a relatively benign one. The Barclays Aggregate Index returned 5.24% and the Barclays Intermediate Government/Credit Index was up 5.08%. Yet according to Morningstar, 65 intermediate domestic bond funds lost -8.00% or more in 2008, with a dozen dropping more than -15.00%. One prominent fund with over a half billion dollars in assets lost more than -35%, another with similar assets dropped more than -20%, while a third started the year with almost a billion dollars before losing in excess of -22%. At the same time, some 50 funds outperformed the 5.24% of the index, but began the year with just a fraction of the assets of the funds which lost investor dollars over the course of the year.

What went wrong with these funds with large losses? You certainly wouldn’t find excess risk in most of their titles, which read “Core Bond, Income, Intermediate Bond, Intermediate-Term Bond, and Total Return Bond” and the like. To understand the risk, you would have had to look under the hoods of these funds, a look that probably required some extra due diligence. As MarketWatch reported in early 2009 in relation to one of the prominent bond fund’s major losses, even more disappointing than the losses was the manager’s “lack of candor in communicating to their fund shareholders just what sort of strategies they were using – strategies that led directly to the staggering losses…” The culprit: high exposure to mortgage-related debt and credit default swaps, securities that might have looked obscure to the careful reader of annual report holdings, but hardly toxic.

What good is high yield when your principal is gored?
In the same year, investors who stretched for yield were likely to be rewarded with a lump of coal. More than 86% of high-yield mutual funds lost -20% or more in the calendar year of 2008. One in six lost more than -30%, and one prominent fund went into the year with $1.6 billion in assets and lost -78.5% of its value over the course of the year.

The Moral: Excess returns typically entail excess risk. The securities which made these once high-flying bond investments attractive almost certainly contained more risk than the investors in these funds recognized until it was too late.

But Won’t I Have Time to Shorten Duration when Rates Start Rising?
If rates moved in a linear fashion, this might be possible. But like all financial markets, short-term moves in the bond market can be erratic and unpredictable. For instance, yield on the 20-year Treasury has risen as much as 156 basis points (1.56%) in one month (January, 1980). Just recently on October 25 and October 26, 2011, the yield on the 10-year Treasury jumped 28 basis points in just two days, and has risen as much as 19 basis points in a day (October 26, 2011). In late 2008 and early 2009, spreads on high-yield corporate bonds widened by some 50% in just three weeks.4

Could the next round of bond volatility get even worse? With more and more money chasing a constrained number of bonds, liquidity could become a huge issue. In a July 15, 2010 paper called “The Illiquidity of Corporate Bonds” Jack Boa from Ohio State and Jun Pan and Jiang Wang from MIT concluded that “we find that illiquidity is by far the most important factor in explaining the monthly changes in the U.S. aggregate yield spreads of high-rated bonds…” Common sense would suggest that this effect of market forces and disparity between supply and demand would be even stronger among less-liquid high-yield bonds.

The Moral: Change can come very quickly and liquidity can be critically important. Do you know how liquid your holdings are?

Summary – Not all Bond Investments Are Made Alike
In almost all these scenarios of bond disasters there were safe havens. So while some bond investors were racking up significant losses, other bond investors were achieving solid positive returns or suffering only minor losses. If capital preservation is an important goal in your bond allocation, then how confident are you that the bonds you own can hold up well if the market gets ugly?

The Moral: If an investor is seeking safety and preservation of capital in the bond market and would react adversely to a significant loss, then it is certainly prudent to temper the search for yield with a cautious approach to interest rate and credit risk.

4Source: Ibbotson. Long-term government bonds are measured using a one-bond portfolio with a maturity near twenty years.

5Source: Ibbotson. Long-term corporate bonds represented by Salomon Brothers long-term high-grade corporate bond total return index.

6Source: Ibbotson. Intermediate-term government bond measured using a one-bond portfolio with a maturity near five years.

7Spreads are the gap between what a corporate or agency bond pays in yield when compared to a similar maturity Treasury bond. Tighter spreads indicate a market which has greater confidence in the issuance then when spreads are at greater disparity.