The Year That Was

by Glenn E. Atkins, CFA

Let's start with the basic facts. Bonds are not designed to double in price. Stocks are. Bonds are designed to provide income. Stocks are designed to provide growth. Conclusion: Bonds are supposed to be less risky versus a whole host of other asset classes and are generally thought of by conservative investors as the place to be for safety.

But a closer examination of the bond world reveals a scene littered with risk – risk arguably higher than many thought possible. Implicit in this assessment of risk is a perfect dove-tail with a research stance we have held for more than 15 years. Our research on companies in the bond market is designed around trying to avoid risk, not incur it. We want the bond to pay interest as stated and principal at maturity. If it goes up in price, that's just an added bonus. If it goes down significantly in price, that's a problem. It's really that simple. Try to avoid risk.

According to some data we recently saw at ArkansasBusiness.com, 7 of the largest 12 bankruptcies in the history of the United States occurred during 2002. Let me say that again. Seven of the 12 largest bankruptcies ever occurred last year. If this were a verbal presentation, I would pause here to let that fully sink in.

We owned not a single bond of any company that experienced bankruptcy last year. Of the top 12 in history we owned Texaco in 1987 when they filed (and bought more after the fact), but that was such a technical bankruptcy sham that it almost doesn't count. The bonds were always fine, although they traded down at the time. We have researched thousands of companies in the last decade and a half and we have made this up-side opportunity versus down-side risk assessment every single time. So far it has served us pretty well.

Having both a fixed income and an equity line of business that are research driven gives us a unique perspective when looking at the balance of this risk trade-off. Sometimes companies do things that are good for stockholders and bad for bondholders, and vice versa. Sometimes you buy the stock when you might not buy the bonds. The reverse is hardly ever true. This is mainly driven by trading and value opportunities, up-side versus down-side risk, liquidity, and the investment profile of the client.

Success in the bond market is largely a function of what you DON'T own, rather than what you do own. Investors should take risk in the stock market because over time you are rewarded for doing so and, conversely, investors should try to avoid risk in the bond market because over time you are not rewarded for taking it. In other words, look at the risk rather than the reward. This is almost universally true in the investment grade bond market. In other areas like junk bonds, hedge funds, and distressed bonds you are paid to take risk, but that's a topic for another day. The research is the same for bonds as it is for stocks, because at the end of the day bonds are just equity with a coupon. The goal is the same, that is, to make money. It's just the prism through which it's viewed that's different.

"Success in the bond market is largely a function of what you DON'T own, rather than what you do own"

Take risk in stocks – that's how you make money.

Avoid risk in bonds – that's how you make money.

2002 - what a year it was.