



# Financial Fables

## Bonds Are For Stability, Not Return

In early July of 1953, the Rattlesnake Fire broke out in the narrow and brush-choked Grindstone Canyon on the Mendocino National Forest. Along with the regular firefighters, a group of twenty-five volunteers from the nearby New Tribes Missions training facility had been called upon to battle the blaze. After a long day, and with the fire seemingly under control, the weary volunteer firefighters sat down to have a quick boxed-meal before walking out of the canyon. For fifteen of the twenty-five missionaries it was to be their last supper.

Fifty years later I stood in that same canyon with my Dad observing the dedication of a memorial to those fallen men. Following tearful remembrances, an inexperienced public information officer was struggling to explain the circumstances that had caused the tragedy. Dad, now in his nineties, shuffled forward causing a murmur as the veteran firefighters turned and explained to those nearby them, that this old man now standing before them was an iconic fire boss and the person who pioneered the use of fire retardant dropping airplanes. Using his cane as a pointer and the canyon as his visual aid, he proceeded to explain how topography, vegetation, and wind currents transformed a tranquil setting into a sudden tragedy.

Fires are a natural and necessary way to clear excess underbrush and rejuvenate forests. Financial markets, also, have natural cycles where excess growth is reduced by periods of decline, contraction, or even recessions. But catastrophic fires, as well as catastrophic market declines, can cause damages that may take years to recover from. One way of eliminating this volatility in portfolios would be to eliminate all investments in stocks. Unfortunately, this would be as unhealthy for most portfolios as it would be to remove all vegetation from a mountain just to prevent forest fires. A deforested hillside would be exposed to significant soil erosion and a portfolio devoid of equities would experience the constant erosion of inflation.

Healthy forest management practices reduce volatile fuel loads to an acceptable level by the use of firebreaks, control burns, and other methods of removing excess vegetation. Healthy portfolio management practices reduce volatility by diversification. But diversification alone can't remove enough volatility for all but the bravest (or maybe craziest) investors, so we add bonds to our portfolios for increased stability. However, not all bonds reduce volatility.

Bond quality, along with term length, determines the volatility of bonds; as the quality declines returns increase, but so does risk. In periods of severe economic distress such as we are currently experiencing, the flight to quality has caused the value of all but the highest quality bonds to fall. In 2008 medium quality bonds were down about 12%, junk bonds dropped more than 25%, and the supposedly safe adjustable-rate bank loans were off by more than 30%. Only the highest quality corporate along with US Government bonds increased in value last year.

Dad knew that you can't eliminate fires from forests and I know you can't eliminate risk from portfolios, but with good management practices you can reduce the losses. Dad used firebreaks to keep wildfires under control and we use bonds to keep portfolio volatility under control. But many bond and fixed-income managers have delivered unexpectedly large losses at precisely the time when stability was most needed because they did not understand the function of bonds in a portfolio. We always keep our bonds high in quality and short in maturity, because we know "Bonds are for stability, not return."