

Best and Worst of Bonds

Last year, investors rediscovered a basic, time-honored truth about the financial markets: Bonds are not a monolithic, invincible asset class. By Craig L. Israelsen

THE PERFORMANCE OF BONDS IN 2008 is best described by Charles Dickens, writing in *A Tale of Two Cities*:

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair.”

Investors often forget that different types of bonds, like stocks, can provide wildly different returns. This was never truer than in 2008.

A YEAR OF EXTREMES

Consider the extreme performance disparity among bond funds in 2008. There were a total of 651 taxable bond funds (distinct funds only) in the Morningstar database that had a full 10-year performance history as of Dec. 31, 2008. As shown in “Going Wide” (page 108), those funds lost an average of 5.1% in 2008, the only negative average return during the past 10 years. The median return was -1.9%, also a first.

The highest return in 2008 among the 651 bond funds was 50%—the highest one-year bond return in 10 years. The worst return in 2008 was a 78.5% loss (posted by Oppenheimer Champion Income A), which eclipsed the prior worst one-year bond return, which was -30.6% in 2000.

The range of returns (from worst one-year return to best one-year return) is another telling sign. In 2008, the range was 128.5 percentage points, ranging from -78.5% to +50%. Over 10 years, the highest one-year range prior to 2008 was 63.3 percentage points, in 2000.

But perhaps the most dramatic statis-



tics from 2008 were the number of bond funds that had negative returns and the average size of those returns. Last year, 58.5% of the 651 bond funds had negative returns, and the average negative return was -13.1%. Both numbers were the highest in the past 10 years.

GETTING TIGHTER

The group of 651 bond funds discussed above contains funds from several categories (short term, intermediate term, high yield, strategic bond, investment grade, etc.). Only two filters governed the selection of bond funds for analysis: They had to have 10 years of perfor-

mance and be a taxable bond fund.

To shed some light on the extreme performance disparity in bond funds last year, let's isolate a more tightly defined subgroup of similar bond funds. This smaller group of funds had to meet several filters: have one year of performance as of Dec. 31, 2008, be a taxable bond fund, be actively managed, be a distinct bond portfolio, have a prospectus objective of general corporate bond and be categorized by Morningstar as an intermediate bond fund.

Imposing a more stringent set of filters produced a subgroup of 146 funds, all of which can reasonably be bench-

GOING WIDE

The performance of taxable bond funds was unusually volatile in 2008. The range of return from maximum to minimum return was 128.5 percentage points, the highest in 10 years.

Bond performance (651 bond funds)*	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Average return (%)	1.23	7.06	6.29	7.32	8.80	5.27	2.18	5.43	5.23	-5.12
Median return (%)	0.51	9.03	7.23	8.02	4.23	4.14	2.09	4.36	5.61	-1.87
Maximum return (%)	36.69	32.65	28.19	26.66	48.02	19.00	17.28	19.37	13.59	49.98
Minimum return (%)	-20.70	-30.61	-26.92	-12.20	-4.44	-0.34	-10.51	-3.12	-7.89	-78.53
Range of return (from max. to min.)	57.39	63.26	55.11	38.86	52.46	19.34	27.79	22.49	21.48	128.51
% Funds with negative annual return	44.9	15.2	8.0	9.7	0.80	0.31	5.8	0.46	2.15	58.5
Average negative one-year return (%)	-2.74	-6.45	-3.33	-3.29	-1.86	-0.26	-5.32	-1.57	-2.16	-13.07

* All taxable bond funds in the Morningstar database with 10-years performance
Source: Author using Morningstar data

marked against the Barclays Capital Aggregate Bond Index (BCABI). The performance of the BCABI in 2008 was 5.2% (which incidentally beat the performance of 79% of the 651 bond funds in the first group).

As shown in “Going Narrow” (right), the average bond fund appropriately benchmarked to the BCABI lost 3.1% in 2008. The highest one-year return was 11.2% and the lowest return was -35.8% (that dubious distinction belonging to Oppenheimer Core Bond A).

Among this group of 146 bond funds, 62.3% had negative returns in 2008. The average loss was 7.4%, dramatically underperforming the 5.2% positive return of the index. Only 14 funds, or 9.6% of the group, beat the index in 2008. More important than a headcount of outperforming funds is the percentage of assets that beat the index—only 2% in this case.

Based on the dramatic performance disparity in 2008, it’s clear that bond funds are hardly a generic commodity, even ones that can be benchmarked against the same index. An observation in my 2008 article, “Bond Fund Blues,” is just as valid today: “The source of performance in a portfolio needs to be understood in order to anticipate the potential risks. In the case of bond

GOING NARROW

A more targeted group of bond funds was somewhat less volatile, with a 47 percentage-point range of return.

2008 Performance of Barclays Capital Aggregate Bond Index	5.24%
2008 Performance of bond funds appropriately benchmarked to the Barclays Capital Aggregate Bond Index (146 bond funds)	
Average return	-3.12%
Median return	-1.84%
Maximum return	11.19%
Minimum return	-35.83%
Range of return (from max. to min.)	47.02
Percentage of funds with negative annual return	62.3%
Average negative one-year return	-7.38%
Percentage of funds beating index	9.6%
Percentage of bond fund assets beating index	2%

Source: Author calculations using Morningstar data

funds, a portfolio with greater exposure to lower-rated bonds presents greater risk. The greater risk is often masked, for a season, by higher returns. It will eventually manifest itself, and when it does, it may exact a higher price than the investor anticipated.” Due diligence when selecting bond exposure requires knowing the credit profile of the bond funds being considered. **FP**

Craig L. Israelsen, PhD, is an associate professor at Brigham Young University, a principal at Target Date Analytics (www.TDBench.com) and author of the forthcoming book, *7Twelve: A Diversified Portfolio with a Plan* (Wiley).

TO TAKE THE CE QUIZ ONLINE, GO TO WWW.FINANCIAL-PLANNING.COM

CE