

# Embrace Boredom

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With the stock market trading near all-time highs and economic uncertainties increasing, it may be time to boost bond allocations. Many investors consider bonds boring and have allowed their bond allocations to drift lower after many years of successive stock market gains. But in a macro-economic environment like this, boring may just be beautiful. If the economy is not already in recession, we believe it is likely to be in one by the first part of 2008. It is difficult to overstate the impact that the extension of credit has had on economic growth over the past several years. The sub-prime mortgage crisis has broadened into an outright credit crunch weighing heavily on overall consumer spending capability. Although the decline may be small, we believe after an unprecedented string of 63 consecutive quarters of real consumer spending growth, the consumer will finally retrench to the point of economic contraction. We don't feel that equity risk premiums fully reflect these risks to economy and therefore we are cutting back client's stock allocations in favor of bonds.

Bonds offer superior protection of principal in uncertain economic times. But not all bond managers or bond funds are created equal. Far too many bond managers have been expanding their investment discipline into areas not indicative of quality bond management. The search for greater returns led many fixed income investors into higher yielding and riskier securities in an effort to make their portfolios more "exciting". At times, this push into other, more exotic sectors of the bond market can be mistaken for sophistication and alpha. However, it can also introduce risk and volatility into portfolios that is inappropriate.

The carnage from poor bond investments is wide spread. From direct losses on subprime, Alt-A and option ARM mortgage investments to SIV's and CDO's, losses have been experienced throughout the financial system. Wall Street firms, from Citigroup to Merrill Lynch, have taken huge earnings hits as they write down asset values to reflect market prices. Even state cash funds from Florida to Minnesota have felt the pinch with billions lost in sub-prime mortgage related investments such as SIV's. All totaled, these losses have topped \$100 billion and many more billions of write-downs are expected. Some analysts expect total losses to eventually reach \$300-\$500 billion or more. As a percent of the economy, these losses would exceed those associated with the Savings and Loan crisis of 1990.

By all accounts, the subprime mortgage crisis has been a bit too exciting and this excitement has now brought surprises. Bond portfolios are not supposed to be full of surprises. Managers who are too inexperienced or forgot the principles of sound fixed income investing have been forced to learn this lesson the hard way (as have their clients). Fortunately, there is an option. Johnson Investment Counsel invests to ensure that your bond portfolio acts like a true bond portfolio during periods of market volatility and economic stress. We have a strict investment grade only, US dollar, no derivative, no surprises policy. This tried and true approach has produced impressive returns in our bond portfolios this year...as it has over much of our history. It's time to embrace "boredom" again.