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THE ADVISOR

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# Optimism Holds as Summer Fades, But Can it Continue?

Through much of July, the financial markets seemed as confused about the future of the economy as the rest of us were about the coronavirus. Investors seemed giddy with optimism one week, wary the next week, then giddy again. That's how most of us are feeling about the pandemic as Covid-19 variant cases spike, and politicians send mixed messages about how cautious we should or shouldn't be. How will this confusion play out as Summer gives way to Fall?

That's a good question considering Labor Day is just a few short weeks away. However, before we look forward, let's look more closely at the past month, which started with all three major market indexes — the Dow, S&P 500, and Nasdaq — hitting new record highs. They all surpassed those peaks again by mid-month. Then came the week of July 15th, which saw sharp declines across the board and ended with all three indexes in the red.[1] The drop was blamed on new concerns about inflation, which until recently seemed to be the only issue capable of even slightly spooking Wall Street.

We say "until recently" because after rebounding to new peak highs by late July, the markets dropped slightly again to end the month, and this time inflation wasn't the culprit. It was the Covid-19 issue and worries over the extent to which the stubborn virus could start to negatively impact the economy again. After the CDC revised its masking policy to recommend that both unvaccinated and vaccinated people wear masks indoors, several major retailers retightened their own policies. Heading into August, concern about the virus was strong enough to overshadow a new batch of better-than-expected quarterly earnings reports and keep the markets muted.[2]

## Double-Edged Sword

In a way, the spike in Covid-19 variants is a double-edged sword for Wall Street. On one hand, if mask mandates and other restrictions tighten further, it could slow the pace of growth just enough to finally eliminate inflation as a concern. In other

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# 4 Reasons to Invest in Bonds

Bonds have a reputation as safe, stable investments. But writing off bonds as boring investments that are best for the risk-averse could be a mistake.

While it's true that investing in bonds tends to lack the dramatic highs (and the lows) that come with investing in stocks, that doesn't mean you should ignore the opportunities bonds present. Here are four reasons why you might want to have a portion of your portfolio in bonds.

**1. Bonds are a way to diversify your portfolio.**

Many financial experts recommend diversifying your portfolio to include a variety of asset classes, including bonds. This is a concept known as asset class diversification. Because different asset classes tend to perform differently at different times, you may be able to create a portfolio that generates more stable returns by investing across asset classes. For example, stocks and bonds tend to historically move in opposite directions, which means that owning some of both can help smooth out the ups and downs in your portfolio.

**2. Bonds are (usually) less risky than equities.**

If you are looking to dial-down risk in your investment portfolio, increasing your allocation to bonds may be one way to do that. However, keep in mind that less risky

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## Optimism Holds

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words, if tighter restrictions lead to fewer shoppers, travelers, and ticket-buyers again, the drop in demand could hold rising prices in check. On the other hand, if demand drops by too much and the recovery completely stalls, investors could start worrying about the whole economy reversing course.

There are other issues that could have major market impacts in the coming weeks as well. As always, one is the Federal Reserve. Will the Fed stick to its ultra-supportive monetary policy when it meets in September? Or will it shift gears by raising short-term interest rates again, perhaps also pulling the plug on some of its quantitative easing? That's an important question because the markets are still influenced more by Fed policy in many ways than by economic fundamentals. As for long-term interest rates, they fell further in July, with the yield on the 10-Year Treasury rate starting August at 1.17% — its lowest level since February.[3] That shows pretty clearly the bond market has a much less optimistic view of the future right now than the stock market does — which only adds to all the confusion.

So, what does all this mean for income investors? It means it's important to continue heeding the lessons we learned from the coronavirus crisis the first time around. Those lessons include making sure your financial plan is providing you maximum protection and adequate flexibility. While the Income Model is designed to check both those boxes, if you haven't reviewed your plan in a while, now is a perfect time to do so. With so much uncertainty brewing, you want to make sure your strategy is as defensively strong as it should be should things go south. At the same time, you want to make sure it's flexible enough to allow you to take advantage of any potential new opportunities that may arise if things restabilize and strengthen.

### Don't Trust 'Autopilot'

That isn't to say that things are "weak" right now. Compared to a year ago, we're obviously in great shape. In regards to the stock market, as of August 3rd U.S. stocks had gone 180 trading days without a pullback of at least 5% — one of the longest such stretches in history, according to Goldman Sachs.[2] However, that's both the good news and the concerning news, especially when you consider the market is overvalued and probably overdue for another correction of at least 10% or more.

The bottom line is that as Covid-19 continues trying to regain strength and the markets continue looking for direction, we urge you to continue trying to maximize the value of your income strategy. Again, that means reviewing it if you haven't recently to make sure it's still providing enough protection and giving you the greatest opportunity to increase your income. Remember, no financial strategy should be left on autopilot, especially at a time when conditions are growing turbulent and forward visibility is low.

[1]Bureau of Economic Analysis, BEA.gov

[1]"Dow Drops Nearly 300 Points on Friday," CNBC, July 16, 2021

[2]"Stocks Turn Lower as Virus Concerns Outweigh Strong Earnings," Yahoo Finance, Aug. 3, 2021

[3]YCharts.com

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## Bond Investing Tips

- **Determine your objectives before investing.** Decide how much of your portfolio you want invested in bonds.
- **Diversify your bond holdings among different bond types.** Consider government, corporate, and municipal bonds, as well as different industries, credit ratings, and maturities.
- **Understand the risks that affect bonds.** The most significant risk is interest rate risk. When interest rates rise, bond values fall, while values rise when interest rates decline. Other risks include default risk, or the possibility the issuer will redeem the bond before maturity; and inflation risk, or the possibility that inflation will outpace the bond's return.
- **Choose bond maturity dates carefully.** When you need your principal is a major factor, but the current interest rate environment may also affect your decision. Rather than investing in one maturity, you may want to stagger or ladder the maturity dates in your portfolio.
- **Follow interest rate trends.** At a minimum, follow the prime rate, Treasury bill rates, and Treasury bond rates. Understand the significance of the yield curve and track its pattern over time. By monitoring current interest rate levels, you will be able to evaluate the appropriateness of an interest rate for a specific security.
- **Compare interest rates for specific bonds before investing.** Interest rates can vary substantially among different bond types and among bonds with different maturities or credit ratings.
- **Research a bond before purchase.** Review the credit quality, coupon rate, call provisions, and other significant factors. Determine whether the bond is appropriate for you in terms of risk, return, and maturity date.
- **Consider the tax aspects.** By comparing the after-tax rate of return for various types of bonds, you may be able to increase your return. Depending on the bond, the interest income may be fully taxable or exempt from federal and/or state income taxes.
- **Review your bond holdings periodically.** Evaluate the credit ratings of all your bonds at least annually to ensure the quality hasn't deteriorated. Also, ensure your holdings are still consistent with your overall investment objectives and asset allocation plan.
- **Call for assistance with your bond holdings.** You should use carefully designed strategies to make bond decisions. Please call if you need help.

## 4 Reasons

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doesn't mean risk free. Bond issuers can default. You also face inflation risk. Because bond payments are set in advance (that's why they're known as fixed-income investments), you lose purchasing power due to inflation.

**3. Bonds can provide a steady, predictable source of income.**

Stocks and other investments are unpredictable — you don't know with any certainty how well a given stock might perform in a certain year or even how well certain types of stocks (like small-cap stocks or international stocks) will do. Bonds are a bit different. They are debt investments, which means you are essentially agreeing to loan an entity, like the government or a corporation, money for a certain period of time. The entity you are lending money to agrees to pay you a certain amount of interest (known as the coupon) over the time they have your money, plus repay your initial investment when the bond reaches maturity. That means that unlike some other investments, you have a pretty good idea of how much money you're going to see from your bond investments over the years.

Of course, bonds aren't risk free. Bond issuers can default, and you could lose your money. That's why riskier bond issuers tend to offer investors higher coupon rates — their greater risk is compensated by greater total return. But in general, bonds are more predictable in how much money they generate for investors, which is one reason why they're so appealing to retirees.

**4. Bonds can provide valuable tax savings.**

Depending on the types of bonds you own, you may be able to save on taxes. While you'll pay normal taxes on corporate bonds, income from Treasury bonds (which are issued by the U.S. federal government) is free of state and local tax. Then there are municipal bonds, or bonds issued by state and local governments. You won't pay federal tax on money you earn on these investments, and you may also be exempt from state and local tax. For anyone who is looking to minimize their tax burden, especially retirees, this can be an appealing proposition.

Questions about making bonds part of your investment strategy? Please call to discuss this topic in more detail.

## Are All Triple-A Bonds Alike?

Unlike stock investors, those who invest in bonds usually have a way to gauge how risky an investment might be. It's the rating assigned to the bond by a credit rating agency, with triple-A being the agency's best rating.

However, not every triple-A rating means precisely the same thing. In fact, two bonds with that same rating can present different possibilities regarding timely repayment of principal. Here's why:

**1. The ratings are relative to the sector.** A fundamental fact bond investors must remember is that the three major bond sectors each present different levels of risk, completely apart from the ratings each bond carries. In general, from the safest to the riskiest, the bond sectors are Treasuries, municipals, and corporates. Ratings agencies like Moody's and Standard & Poor's, two of the largest companies in the bond rating business, use the same scale for every bond sector. Each sector has a list of triple-A rated bonds, but that doesn't mean a triple-A rated Treasury poses the same level of risk as a triple-A muni or corporate does. The same goes for each rating and category.

**2. Ratings are opinions.** Financial ratings are opinions and, as such, are as much art as science. Ratings are based on a careful review of the numbers, and each rating agency has its own general guidelines for which numbers go with which rating. Opinions can vary not only between credit agencies, but even between different analysts within the same agency. And after all, no one is perfect when it comes to predicting the future, and that's what ratings are supposed to do.

**3. The issuers pay for ratings.** The rating agencies make their money from the fees they charge bond issuers. Ostensibly, the agencies are able to command the respect of the marketplace by remaining objective, despite the potential for this arrangement to affect their judgment. Nevertheless, the outcry over toxic mortgage-backed securities, many of which were rated triple-A, has cast a shadow of doubt over just how objective the rating agencies may or may not always be.

**4. Things change.** In all fairness to the rating agencies, our global economic and financial systems are incredibly fast-changing. Knowing that, the agencies try to keep up, and often come out with new ratings as issuers' circumstances change, either for the worse or the better. Credit downgrades and upgrades are quite common, but with tens of thousands of bond issuers, the agencies can't keep up with changes in every issuer's circumstances.

**5. Bond insurance can mask problems.** It's not uncommon for issuers of municipal bonds to secure bond insurance. In that case, the bonds assume the credit rating of the bond insurance company, regardless of the state of the issuer's finances. If times got tough for state and city governments and a large number of them were to get financially weaker, it may be beyond the wherewithal of the municipal bond insurance industry to make every bond investor whole, in spite of its high rating.

## Business Data

| Indicator | Month-end May-21 | Jun-21 | Jul-21 | Dec-20 | Jul-20 |
|---|---|---|---|---|---|
| Prime rate | 3.25 | 3.25 | 3.25 | 3.25 | 3.25 |
| 3-month T-bill yield | 0.02 | 0.05 | 0.05 | 0.10 | 0.11 |
| 10-year T-note yield | 1.58 | 1.45 | 1.24 | 0.93 | 0.55 |
| 20-year T-bond yield | 2.18 | 2.06 | 1.81 | 1.45 | 0.98 |
| Dow Jones Corp. | 2.33 | 2.29 | 2.14 | 1.93 | 2.06 |
| GDP (adj. annual rate)# | +4.30 | +6.30 | +6.50 | +4.30 | -31.40 |

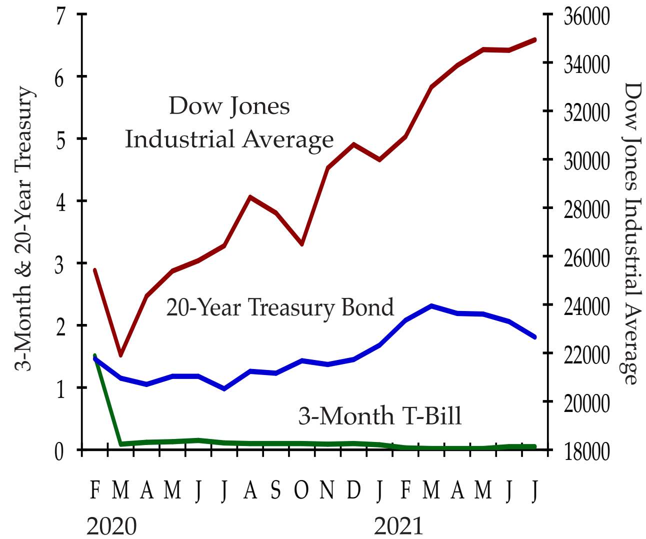
| Indicator | Month-end May-21 | Jun-21 | Jul-21 | % Change YTD | 12 Mon. |
|---|---|---|---|---|---|
| Dow Jones Industrials | 34529.45 | 34502.51 | 34935.47 | 14.1% | 32.2% |
| Standard & Poor's 500 | 4204.11 | 4297.50 | 4395.26 | 17.0% | 34.4% |
| Nasdaq Composite | 13748.74 | 14503.95 | 14672.68 | 13.8% | 36.6% |
| Gold | 1899.95 | 1763.15 | 1825.75 | -3.3% | -7.1% |
| Unemployment rate@ | 6.10 | 5.80 | 5.90 | -11.9% | -46.8% |
| Consumer price index@ | 267.05 | 269.20 | 271.70 | 4.4% | 5.4% |

# — 4th, 1st, 2nd quarter @ — Apr, May, Jun Sources: *Barron's, Wall Street Journal*

Past performance is not a guarantee of future results.

**18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield**

February 2020 to July 2021




# Consider a Bond Tent

The good news is you finally saved enough to retire and now have a large portfolio. The bad news? If the market takes a serious downturn, the impact to your portfolio could be a disaster. The money you thought you would live on for the rest of your life could end up falling short.

History has shown that the sequence of returns generated by a portfolio from one year to the next can hugely impact the total return generated over time. While long-term average returns impact how much money you make, the timing of those returns is equally important. For example, if you retire at the bottom of a bear market, you will see your holdings rise as the market recovers, but you will also see the overall portfolio growth reduced because of the amount of money that was withdrawn in early retirement.

An important strategy to consider is building a bond tent before you retire. This strategy increases the allocation of bonds during the 10 years or so prior to retirement, and then the bonds are sold from this portion of your portfolio during the first 10 to 15 years of retirement, providing you with an income stream.

This strategy is called a bond tent because if you were to look at it on a line graph, the bonds in the portfolio steadily rise until it reaches a peak at retirement and then falls as the bonds are sold, which makes a tent shape.

The strategy works by reallocating a traditional 60/40 mix of stocks and bonds to an allocation of 50% or 60% in bonds by the time you retire. The bond holdings are then sold during the first half of retirement until the original mix is once again reached. This provides portfolio protection against major losses due to a market downturn during the first half of retirement. The portion of your portfolio that is still in stocks will continue on the path for long-term growth to fund your later years of retirement as well as provide protection against inflation.

Please call if you'd like to discuss bond tents in more detail.

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