A Sudden U-Turn in Bond Flows

By Editor Test *Thu, Jun 27, 2013*

Since I (full disclosure) own shares in Vanguard Total Bond Market Index Fund, I feel compelled to fret. So I spoke with Chris Philips, a senior market strategist in Vanguard's Investment Strategy Group.

Is it time for bond owners to panic? That may depend on why they're holding bonds in the first place, or how they financed their bond positions.

Some people *are* panicking. U.S.-listed bond mutual funds and exchange-traded funds posted an all-time record net outflow of $61.7 billion in June (through June 24), according to TrimTabs Investment Research. That broke the previous record of $41.8 billion set in October 2008.

"Before June, bond funds had posted inflows for 21 consecutive months," said David Santschi, CEO of TrimTabs. He attributed the reversal to Fed chairman Ben Bernanke's hints in May that he might scale back the Fed market interventions that have propped up prices for bonds of all credit qualities and durations.

On June 24, San Diego financial pundit Bill Gunderson sent out an e-mail blast that said, "Here's the one thing people do not know about the market right now: This is no time to be in bonds. At some point, Bernhanke [sic] must take away the punch bowl. And when that happens, bonds will be punished even more than the 8% decline they have suffered since the beginning of the year."

In case words alone weren't sufficiently scary, Gunderson also issued a newsletter with a picture of the Massacre at Little Big Horn (aka Custer's Last Stand) and a chart illustrating the fall in share the price of Vanguard Total Bond Market Index Fund—to $80, a 5% paper loss—since May 1.

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***RIJ*:** I comfort myself that during periods of rising rates a bond fund's price is supposed to recover in a time period roughly equal to its average duration, because the manager keeps reinvesting at higher yields. Is that a valid rationale?

Philips: It almost never holds up in reality because of credit-spread timing and other factors. But it's based on a kernel of reasonable intuition and relationships over time. It's one of those rules of thumb that [bond fund owners] can use to gauge their general risk exposure.

***RIJ*:** Still… there's been an 8% decline in six months. Time for a gut-check, no?

Philips: The Vanguard Total Bond Market Index Fund is down 3.2% year-to-date. Its worst year historically was negative 9.2%. Gunderson says bonds are off 8%; he might be talking about long-term Treasuries, which is the worst-case scenario. To put the risk of bonds in perspective, we would point out that during the financial crisis, housing prices dropped 50% in some places, dividend-paying stocks lost 55% and the overall market lost 50% at one point. While there are other income sources, they come with different or greater risks than bonds.

RIJ: Let's suppose that *I* restrain myself from panicking, but millions of my fellow bond fund owners don't. Won't the bond fund manager have to start dumping bonds at big losses to cover all the redemptions?

Philips: There's the possibility of a forced sell-off, but the amount of [negative] cash flow that would have to occur is tremendous. If you look at all of the sources of cash flow in the Total Bond Market Index Fund, including money from institutional investors and target date fund investors in 401(k) plans, the probability of everyone deciding to pull money out is small. In large funds like Total Bond Market or PIMCO Total Return, you always have a lot of securities coming to par. There's a lot of money to work with. Even in 2010 and 2011, when we had the perceived crisis in the municipal bond market, not one of our muni-bond funds experienced forced selling.

RIJ: It's hard to accept the fact that the 30-year bull market in bonds is actually over.

Philips: Despite all the fear about rising rates, it would be worse for yields in all income securities to remain low. In contrast to an environment of financial repression, where people who rely on certificates of deposit have been penalized not only by the Fed but also by the flight to fixed income, rising yields is a good thing. We'd rather have a market with historically normal rates than rates that are historically high or low. Ultimately, it gets down to how rising rates occur. In the period of 2003 to 2006, the Fed was very open about how and when they would raise short-term rates, and the market had a lot of room to price in the changes.

RIJ: Is there a buying opportunity here? Can you 'buy the dips' in bond prices as you might in stock prices?

Philips: 'Buying the dips' is a timing mentality, which we don't recommend. On the other hand, if your target allocation for fixed income is 50% and you're below that because of the share price decline and you had the cash, it might make sense. That's where dollar cost-averaging comes in.

RIJ: Thanks, Chris.