OPENING SHOT
JAMES K. GLASSMAN

My New Take on Bonds

An important investing lesson of the past few years is that stocks aren't everything. A pile of cash may not grow into a bigger pile of cash, but it has the virtue of permanence. Shares of Lehman Brothers or Washington Mutual may vaporize, but cash—by which I mean money-market funds, savings accounts and Treasury bills—will remain loyal and liquid.

Most bonds have limited potential for appreciation, but if they are well chosen, they provide a steady flow of cash. And if the worst happens and a company fails, bondholders get paid before shareholders, who are sometimes left with nothing at all.

Revised advice. Because of the wretched experience of the past few years—and the likelihood that the U.S. economy will grow sluggishly in the future as the nation deals with a huge load of debt—I recommend that investors hold less in stocks and more in cash and bonds than in the past. Precise allocations depend on your age, savings cache and risk tolerance. But if in the past you held 70% in stocks, 20% in bonds and 10% in cash, I suggest that you keep 50% in stocks, 30% in bonds and 20% in cash.

Cash and bonds have something in common: Both are debt. Typically, cash-type investments keep pace with inflation, but don't do much more. At the beginning of August, the national average yield for a taxable money-market fund was just 0.1%; for a six-month certificate of deposit, 0.8%. Historical averages are much higher—about a half-point above the long-term inflation rate of 3%.

It is probably no surprise that, despite low nominal returns, cash was a popular refuge as stocks were collapsing. Moving from stocks to cash as shares fall (and from cash to stocks as shares rise) is *not* the road to riches. The portion of cash in your portfolio should either remain fixed or increase during bull markets in anticipation of deployment when stock prices fall.

Bonds offer different levels of risk, depending on who is borrowing from you, how long it will be before the issuer pays you back, and whether there is a ready market for bonds you want to cash in prior to maturity.

In the past, I have recommended Treasury bonds exclusively. The additional risk of corporate bonds did not seem to be worth the additional reward. High-quality, long-term corporates have returned only about a half percentage point per year more than no-risk Treasuries of similar maturity. Over the past 50 years, the returns of corporates rated Baa by Moody's (on the lower range of the investment-grade spectrum) have exceeded those of Treasuries by about two points per year—not enough for me to abandon the comfort of lending to the federal government. If you want to reach for return, I reasoned, then buy stocks, which offer greater potential.

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Now I am taking a hard look at the entire bond universe. Interest from Treasuries still carries the advantage of being exempt from state income taxes. Payments from municipal bonds are exempt from federal and often state income taxes, too. But many muni issues don't trade frequently—no problem if you hold them to maturity, but potentially harmful if you want to sell early.

Data collected since 1926 by Ibbotson, a unit of Morningstar, show that shares of large companies, as measured by Standard & Poor's 500-stock index, have returned, on average, about four percentage points more per year than intermediate-term Treasury debt. The data suggest long-term investors should give substantial preference to stocks—which represent direct ownership in a company—over bonds.

More recent returns, however, tell a different story. Over the past ten years, intermediate Treasuries have beaten stocks by an average of nearly eight percentage points per year. Over the past 40 years, stocks beat bonds, but by just 1.2 points per year. The reasons are declining interest rates (which raise the value of bonds) and, lately, poor stock returns.

Peng Chen and Roger

Ibbotson wrote recently on the Morningstar Web site: "Some even argue that investors should allocate entirely to bonds, not only because bonds are the safer investments, but because they believe bonds will outperform stocks over the long run. In other words, if bonds can deliver higher returns with less risk, why bother with stocks?"

Taking the longer view, the authors—who are, respectively, the president and founder of Ibbotson Associates—opt for stocks. I concur, in part because interest rates will almost certainly rise (causing bond prices to fall) as inflation heats up in a few years.

Still, I think bonds have achieved a new luster. So does Jim Roumell, president of Roumell Asset Management, in Chevy Chase, Md. Roumell, a value investor, gained renown in 2002 as a multiple winner of the *Wall Street Journal*'s pros-versus-dartboard stock-picking contest, and I have followed him ever since.

Safe tree. His approach to asset allocation is unusual. Roumell sees cash as a "home base." "Think of when you were a kid and played a game where a tree gave you immunity from being tagged," he says. "The tree was safe. You might go out 20 or 30 feet, but you only came off the tree when the odds were in your favor."

Roumell's strategy is to keep a bundle of cash (30% of the typical portfolio today), then make opportunistic investments in a relatively small number of stocks and bonds. He currently has 35% of his portfolio in stocks, the same in bonds and the rest in cash.

Since early 2009, Roumell has been especially enthusiastic about low- to medium-grade corporate bonds. In his first-quarter letter to investors, for example, he listed Stone Energy Corp. notes, maturing in 2011, among his top three purchases. Because the price of Stone's debt was severely depressed, the notes were yielding 20% to maturity.

Numbers Duel

STOCKS SAG, BONDS STEADY

Because Treasury bonds clocked stocks over the past decade, the latter's long-term advantage has narrowed. But with yields so low today, it will be hard for Treasuries to turn in a repeat performance.

	Annualized return		
Period*	S&P 500	Medium-term Treasuries	Long-term Treasuries
1 year	–26.2%	5.5%	7.7%
5 years	–2.2	5.1	7.1
10 years	–2.2	6.0	7.6
20 years	7.8	6.8	8.6
30 years	10.8	8.3	9.5
40 years	9.2	8.0	8.5
January 1926–June 2009	9.6	5.3	5.5

*All periods ended June 30. SOURCE: Ibbotson Associates, a Morningstar Inc. company

Roumell's analysis showed that "the value of the company's assets, primarily proved oil and gas reserves, exceeds that of its outstanding obligations" by a great enough amount to offer a significant margin of safety. If Stone failed and had to be liquidated, Roumell reasoned, bondholders would be paid off—likely in full—before stockholders.

The best time for buying corporate bonds, however, may be past. About a year ago, the Barclays Capital High Yield Very Liquid index, a measure of below-investment-grade, or junk, bonds, was yielding an unprecedented 20%. But few investors had the courage late last year to reach for corporate debt at a time when the market for even medium-quality issues had nearly shut down. The spread between yields on Baa-rated corporates and Treasuries hit 6.1 percentage points last December and remained greater than five points in May. By the end of July, the gap had dropped to 3.5 points—still about twice the average of the past 50 years.

At the end of the second quarter, Roumell wrote that in terms of risk versus potential reward, corporate bonds appeared to be more attractive than stocks, "enabling investors to earn income through interest payments and effectively lock in substantial multiyear returns." Today, he is looking for bonds that yield more than the average historical return on stocks—about 10% and up. Among his discoveries is the B-rated (speculative) debt of Leucadia National, a diversified holding company that is often compared to Warren Buffett's Berkshire Hathaway. Leucadia's bonds maturing in 2027 and bearing an interest coupon of 8.65% were trading at a sizable discount in late July, so that their yield to maturity was, in Roumell's words, a "ridiculously high" 12%.

He showed me his analysis of Leucadia's balance sheet. The company had about $2.3 billion in debt and $6 billion in assets at market prices, including more than $500 million in cash and government bonds. Even after cutting the value of those assets to $4 billion, for safety's sake, he still believes there is a nice cushion.

I agree that corporate bonds are still attractive, but I don't think the average investor should try to emulate Roumell at home. If you can't afford a manager like Roumell, you can buy bond mutual funds—high-yield and otherwise. Good choices include **VANGUARD HIGH-YIELD CORPORATE (SYMBOL VWEHX)**, with an expense ratio of only 0.27% but a 1% redemption fee if you withdraw within a year of investing, and **ISHARES IBOXX $ INVESTMENT GRADE CORPORATE BOND (LQD)**, an exchange-traded fund that invests in high-grade corporate debt. Annual fees are just 0.15%. The funds sport current yields, respectively, of 7.9% and 5.4%. ■

JAMES K. GLASSMAN, PRESIDENT OF THE WORLD GROWTH INSTITUTE AND FORMER UNDER SECRETARY OF STATE, HAS A NEW BOOK ON INVESTING COMING OUT NEXT APRIL.