Why bonds still matter: How to build a portfolio that helps you weather changing markets

Video Transcript

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Featuring:

Michael Santoli, Senior Columnist, Yahoo! Finance
Matthew Diczok, Head of Portfolio Solutions for Merrill Lynch Wealth Management

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MICHAEL SANTOLI: Hello, I'm Michael Santoli, senior columnist at Yahoo! Finance, and I'm here today with Matthew Diczok, head of portfolio solutions for Merrill Lynch's Investment Management and Guidance group.

Today, Matt will help us take a closer look at why investors shouldn't neglect the value of bonds in their investing strategy, and how to include them in their investment mix.

Section 1: Why do you need bonds?

So, Matt, let's start right there. Why does an investor in today's environment need bonds, given the fact that the Federal Reserve is backing away on its bond-buying program and there's lots of uncertainty out there about the direction of interest rates?

MATTHEW DICZOK: Thanks, Michael. That's a great question. What we really want investors to focus on is it's important to always build a portfolio that's going to be resilient to a number of different potential future markets, not based on any particular one forecast.

So investors should really focus on what can they control. What are their investing goals? Why are they investing? What's their investing time horizon? What are the potential cash flow and liquidity needs they have?

With that firmly in mind, they should then think about what risks are they really willing to take to meet those goals. How have they reacted to market fluctuations in the past? How might they react to potential market volatility in the future that might hinder them from actually achieving those goals?
So when you think about that—your goals and your risk tolerance—you'll generally find that bonds should play a role in your diversified portfolio in any market environment, including the current one.

There are three reasons for that:

- First, bonds generally are not as variable in price as stocks are. They historically have not moved as much.
- Secondly, bonds can actually move in a different direction than stocks. They can be what we call “negatively correlated.” When stock prices fall, bond prices can actually rise. That's not always the case historically—they both can drop in price together—but many times they will move in different directions.
- Third, bonds can also provide a steadier income stream than stocks.

So you take those three considerations together—the fact that they can be less variable in terms of price, the fact that they can move in different directions, and the fact that they can steady your income—you'll generally find that bonds will be able to cushion your portfolio in a down market at the expense of underperforming in a rising stock market.

**MR. SANTOLI:** So in order to capture bonds' value as a diversifier, what percentage of a portfolio should be allocated to fixed-income investments?

**MR. DICZOK:** Well, Merrill Edge investors have an excellent resource available to them—the Research Investment Committee report, or RIC report for short. This is a publication dedicated to individual investors published by Bank of America Merrill Lynch Research. Essentially, one of the components of the report is the firm’s strategic asset allocation—our recommended starting point for investors with a long-term time horizon, say 20 years plus.

For example, for a conservative investor, strategic asset allocation recommends as a starting point now, 20 percent to equities, 55 percent to fixed income, and 25 percent to cash. If your risk tolerance is aggressive, you could be up to 80 percent in equities, 15 percent in fixed income, and 5 percent in cash. So that's important to note—that even for the aggressive investor, someone for whom above-average portfolio appreciation is the goal, there's still 20 percent invested to fixed income and cash, highlighting that a diversified portfolio is important.
Section 2: Allocating your bond investments

MR. SANTOLI: All right. So once an investor has settled on a target percentage for bonds in his or her portfolio, what are the categories of bonds that should be considered?

MR. DICZOK: Well, the RIC report can also be a great starting point for trying to think about how you want to build within that bond portfolio. So we'll go through the various bond sectors: U.S. Treasury bills, notes and bonds, Certificates of Deposit, agency bonds, mortgage-backed securities, corporate bonds, both investment grade and high-yield, and international bonds.

So if you're a conservative investor, the recommendation will be to predominantly have most of your fixed-income assets in U.S. Treasuries, agency bonds, Certificates of Deposit. As your risk tolerance increases to aggressive, you can have more credit risk in your portfolio. So, a higher allocation to investment grade, as well as some high-yield and international bonds in modest amounts.
MR. SANTOLI: Staying on that subject of risk, obviously different categories of fixed income have different kinds of risk associated with them. What are the specific risks you think that an investor should keep in mind if the chief role for fixed income is to diversify a stock portfolio?

MR. DICZOK: Merrill Lynch really wants individual investors to understand what we perceive to be the risks in the current market, and if you think about where we were prior to the financial crisis, you could easily achieve a yield of 5 percent plus in the U.S. Treasury market. If you're trying to get that same yield in today's market, you have to invest in the bonds of a speculative grade high-yield company, so significantly more risk.

And unfortunately there's no magic solution in this market. You're either going to have to take additional credit risk, liquidity risk, or currency risk to try to achieve that same yield.

So to bring it back to an investor who primarily wants to use bonds as a diversifier for a stock portfolio, he should have a conservative allocation and should be primarily invested in U.S. Treasuries, because historically, they have been the least correlated to the stock market. Now, if you still want to have that diversifier of stocks but want potentially slightly higher yields, you can invest in longer dated U.S. Treasuries and realize you're just taking more interest rate risk to get that higher yield.

The one thing we want to make sure investors don't do is pretend that they want bonds as a diversifier for their stock portfolio and also try to achieve excessively high yields. Because if you say you want bonds as a diversifier to try to reach for those higher yields, you'll find, in a down market, you won't get diversification or those high yields.

MR. SANTOLI: That's definitely a key point. So after coming up with a percentage allocation to fixed income, and then the categories of bonds that we might want to include, what specific vehicles should an investor consider to access those markets?

MR. DICZOK: Unfortunately bonds, unlike stocks, are not traded on a stock exchange. So it's not cost effective or efficient for most individual investors to build a diversified portfolio with individual bonds. So we generally recommend that investors first look to funds.
ETFs and index funds are a very efficient, low-cost way to build a diversified portfolio across bond markets or individual sectors.

You could also look at actively managed mutual funds. And these are funds where a manager can under-weight or over-weight certain sectors to try to outperform a benchmark at the risk obviously of underperforming a benchmark.

So investors who want broad allocation to an entire market should think about multi-sector funds.

- A Core bond fund, for instance, will give you access across the U.S. investment grade markets.
- A Core Plus fund will give you that access as well as add some high-yield and international exposure.

Now, two things we want to highlight to investors:

First, never choose a fund on name alone. You can certainly find funds with very similar names, but very different risk profiles. Look under the hood. See what sectors they're invested in. Make sure the risks of the funds line up with your particular risk tolerance.

And secondly, we want investors particularly in this low rate environment to keep a close eye on the fees and expense of any funds they're looking at. Fees and expenses can be a significant drag on your after-tax, after-fee, after-inflation returns.

**Section 3: Know your goals, time frame and risk tolerance**

**MR. SANTOLI:** You've run through a lot of important information here, Matt. What are the key messages you would hope an investor would take away from this discussion?
MR. DICZOK:
First, don’t think about bonds as an individual asset class. Think about your entire asset allocation, your entire portfolio. Really focus first on articulating your specific personal investing goals.

Secondly, before you think about your bond stock allocation, think about your risk allocation. Think about how much you have in cash versus how much you have in the market.

Getting those two things right-sized will hopefully stop you from moving assets out of the market and into cash at the wrong time.

Third, you want to really build a portfolio that’s designed to be resilient to a host of potential future markets, not dependent on any one forecast.

In terms of fixed income in particular:

To build your fixed-income portfolio

1. Bonds are a very useful asset class

2. Understand the broad types of bonds available

3. Consider using funds for low-cost diversification

4. Don’t reach for yield unless you understand the risks

- Bonds are a very useful asset class, even if income’s not a core goal. Think back to the Aggressive investor where we still recommended a 20 percent allocation as a starting point to cash and fixed income.
- Secondly, understand the broad types of bonds available, the characteristics of each and how they might relate to the stock market.
- Third, think about using funds as a low-cost, diversified way to get access to those markets.
• Fourth, don't reach for yield unless you understand specifically the risks you're taking. Understand that in this low rate environment, you can't achieve higher yields without taking significantly more risk.

If you're a Merrill Edge client with a Financial Solutions Advisor, he or she can work with you to understand your particular investing goals, your risk tolerance and start to design a portfolio that will hopefully help you meet those goals.

If you're using Merrill Edge to invest on your own, you can make available to yourself the information, tools, and screeners we have available for asset allocation, investment selection, and rebalancing. And you can find these at merrilledge.com/bonds.

MR. SANTOLI: Well, great, Matt. Thank you very much for all those tips and insights.

I hope you gained some helpful information, and I invite you to learn more by visiting merrilledge.com/bonds. I'm Michael Santoli. Thank you for watching.

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Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

Investments in high-yield bonds may be subject to greater market fluctuations and risk of loss of income and principal than securities in higher rated categories. Investments in international bonds involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments.

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Preferred stocks may be subject to call provisions resulting in the risk of investing proceeds at lower market rates and liquidity may be affected by the size of the issue and its trading activity.

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For more complete information on any mutual fund, clients should be provided the prospectus, and/or if available, the summary prospectus, and should read it carefully. Before investing, they should carefully consider the investment objectives, risks, and charges and expenses of a fund. This and other information can be found in the fund’s prospectus and/or, if available, summary prospectus.

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