LAWSON KROEKER

As we see it

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"An investment in knowledge pays the best interest."
- Benjamin Franklin

Financial markets are difficult to understand. They are the aggregate result of millions of individual decisions, each with its own (not always sound) reasoning. Investors seek to make sense of this complex dynamic and sometimes over-simplify. One such simplification we see today is the view that bonds should be avoided because interest rates are so low. Historically, bonds were held for three primary reasons: 1) income generation, 2) creating overall total return, and 3) maintaining portfolio stability, with income normally the focus.

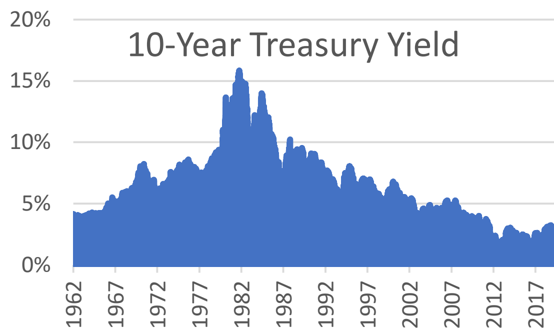
Fixed income securities are typically far less volatile than equities. Like a ship's ballast—which is designed to keep the vessel upright in stormy seas—bonds can be used to offset the volatility found in the stock market.

It is interesting how much bond investing has changed over the past decade or so. Prior to 2008, you could generally find fixed income securities that provided sufficient yield to meet client needs **and** provided portfolio stability and diversification. With the decline in interest rates, investors have had to largely choose between generating income or stabilizing their portfolios. This is because bonds that produce higher yields often fail to diversify the risk from your portfolio, and bonds that provide stability fail to produce much income.

Investing in fixed income securities with a focus on income generation can lead to suboptimal results. Investing history is full of stories of securities that appeared to be low-risk investments until they weren't. The markets will determine where the general level of interest rates will be, and it is up to the investor to recognize where they should invest on the risk spectrum. Generally, the following table applies:

Longer Maturities	Higher Income	Greater Price Risk
Shorter Maturities	Lower Income	Less Price Risk
Lower-Rated Bonds	Higher Income	Greater Price Risk
Higher-Rated Bonds	Lower Income	Less Price Risk

Therefore, if you were trying to maximize income you would have invested in lower-rated, longer-maturity bonds. This investment often performs much more like an equity portfolio and does little to cushion the volatility of the equity markets. Alternatively, if you were trying to dampen potential portfolio volatility, you would have invested in shorter-maturity, higher-quality bonds. This investment, unfortunately, doesn't add much to the current yield.



While we don't see much current impetus to end what has been a 37-year decline in interest rates, it is important to recognize what factors might cause a reversal. One might expect resurgent inflation, higher Fed-induced-short-term rates, and less government purchases of long-dated bonds to reverse the long secular decline in interest rates. Given that we are currently at a historically low unemployment rate, expectations of wage growth would have to raise inflation expectations for actual inflation to begin. Without such a scenario it is hard to see interest rates rising to anywhere near what most investors think they require for bonds to be considered a viable income investment.

On the flip side, wage inflation could remain subdued—and there may be enough slack in the economy to thwart pockets of inflation. As the US currently has higher interest rates than the majority of the developed world, it is hard to see interest rates turning up anytime soon. Markets rarely reward the first economy to raise interest rates.

Which brings us back to where we began. Markets are difficult to understand, much less predict. Therefore, we believe it is prudent to assess your investment objectives and risk tolerance. With this in mind, you can build a portfolio that is appropriate given your time horizon and overall circumstances. A focus on the bigger picture will generally allow you to ignore short-term market noise and may even allow you to build a portfolio that includes bonds.

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