

Rinehart Wealth Management

Greater Trust

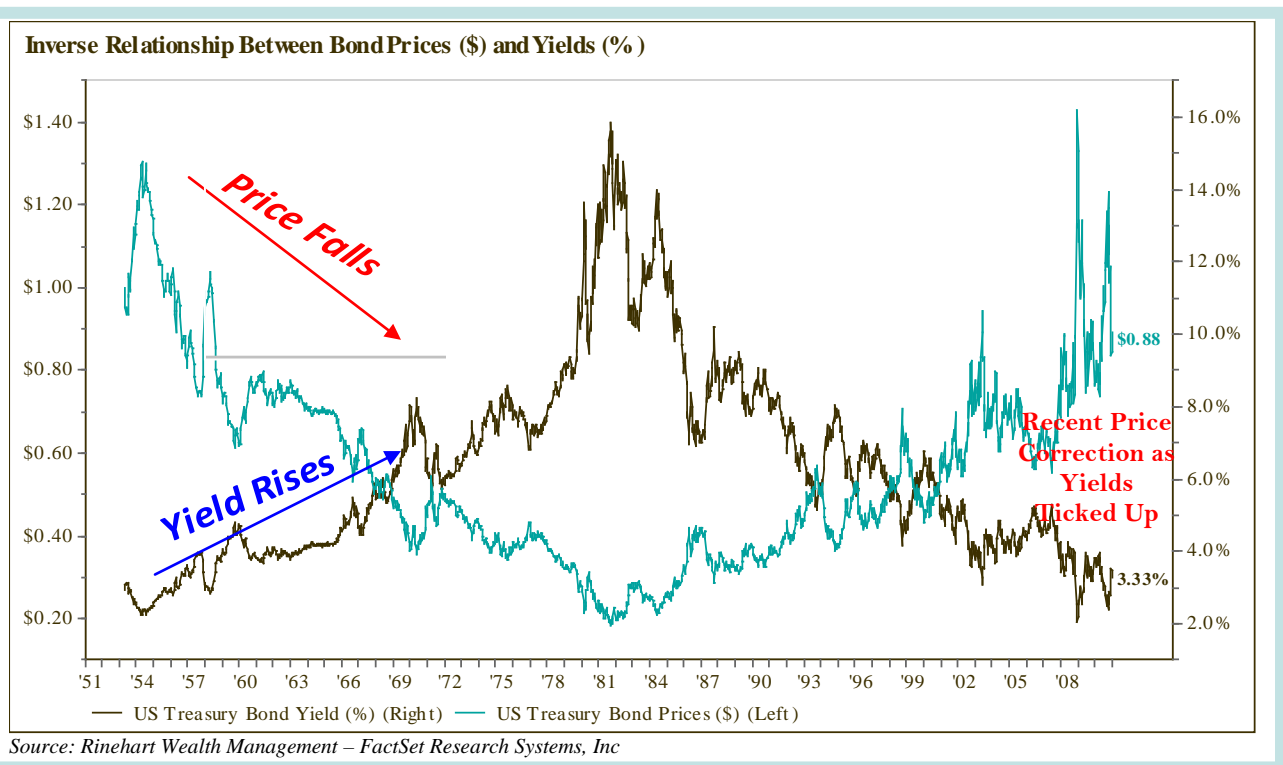
The Bonds Are Falling! The Bonds Are Falling!

Bonds 101

In order to appreciate the reasons for the sudden decline in bond prices, it is important to understand some basic bond concepts. Bonds are **not** risk-free vehicles. The two main risks inherent in bond investing are interest rate risk and credit risk.

Interest Rate Risk

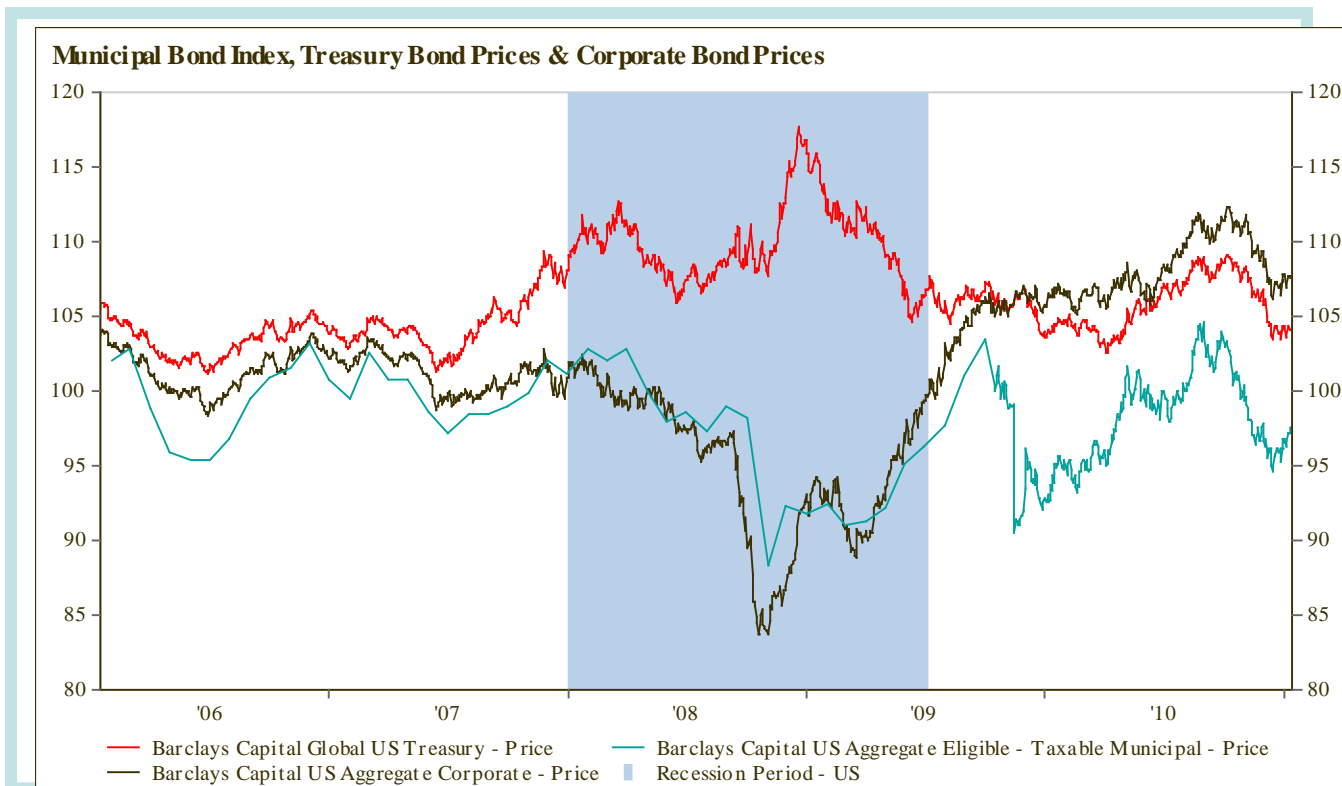
Bond prices have an inverse relationship to yields (the interest you earn on your bonds), meaning that when yields go up, bond prices fall. “Duration” is the term used to define how a bond reacts to change in interest rates and is expressed in number of years: bonds with shorter durations are less affected by changes in interest rates. Below is a chart outlining interest rate risk. The blue line shows the steady rise in bond prices, while the black line depicts the simultaneous fall in yields. Toward the end of 2010, we saw a sudden drop in bond prices as yields ticked up. Utilizing short-and intermediate-term bonds is one way to manage rising rates, so in a rising rate environment, it is beneficial to seek active management.



Credit Risk

Bond prices are also affected by credit concerns. When there is fear of default, investors require a higher yield for holding the riskier bond. As credit risk increases and yields rise, bond prices fall. By comparing different bond market performances over the past several years, we can see

how credit risk has affected prices. The chart below shows the performance of the Municipal Bond Index (green line) relative to corporate bonds (black line) and treasury bonds (red line). In the height of the financial crisis (4Q 2008) both corporate and municipal bonds significantly underperformed US treasuries, because investors wanted to own the highest-quality bonds with the least amount of default risk. As the market began to recover, corporations cleaned up their balance sheets and as credit default concerns decreased, corporate bonds began to outperform. Recently, the Municipal Bond Index has exhibited a more severe price correction relative to both corporate and treasury bonds due to concerns over liquidity at the state and local level. We believe the reason for this performance divergence has to do with the perceived inferiority of municipal balance sheets relative to those of US corporations. In short, investors believe there is a higher credit risk associated with municipal bonds so investors are demanding higher yields, which keeps the municipal bond prices low.



Source: Rinehart Wealth Management – FactSet Research Systems, Inc.

Reasons for the Recent Decline in Bond Prices

The recent weakness in the bond market is the result of several concurrent factors that have raised interest rate levels: inflation concerns, improvements in the equity market and the unraveling of a massively overbought bond market. We are not shocked by the turn in the bond market, because extremely low interest rates were unsustainable if the economy improved. In fact, the current weakness in the bond market is being driven by perceived accelerated growth in the economy and robust relative returns in the equity market, so its falling prices are not necessarily a bad thing for the total portfolio: the allocation to equities is outperforming.

Inflation and Bonds

Inflation plays a large role in driving interest rates and, consequently, bond performance (for more information on this relationship, please see our July, 2010 Newsletter: Inflation Concerns

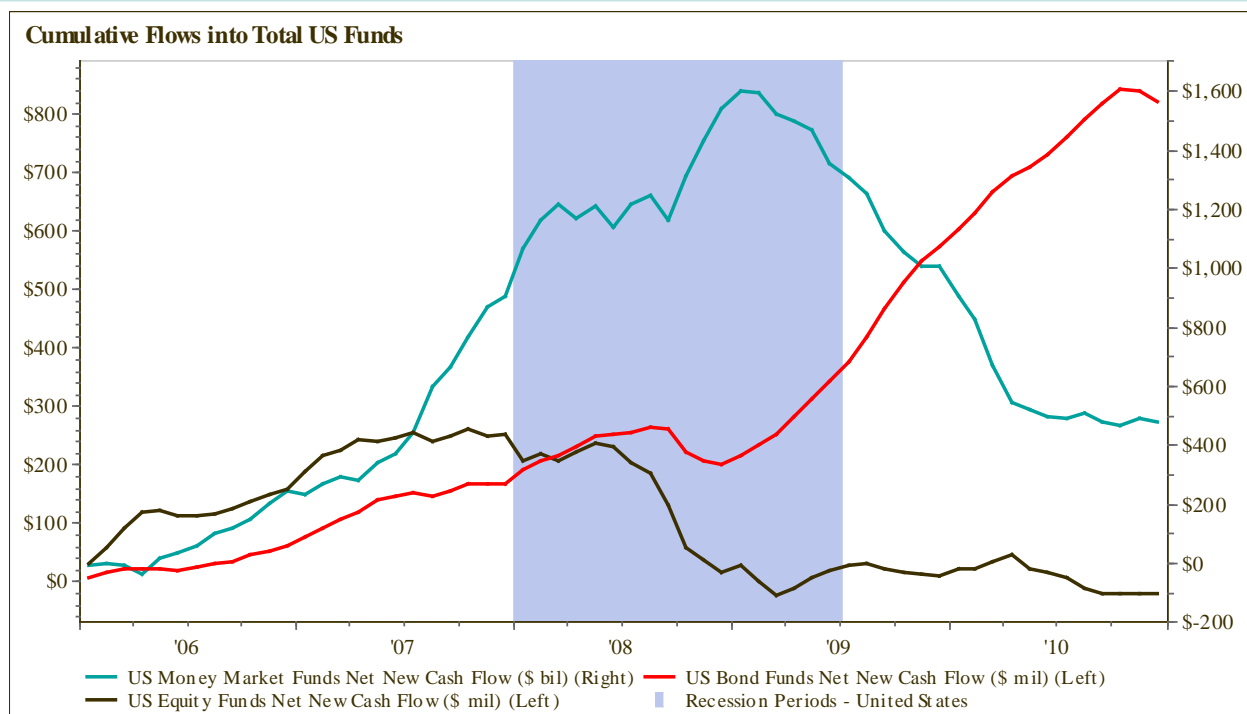
and Implications for your Portfolio). Over the past 20 years inflation has been negligible, serving as a massive tailwind for bonds. With the government's adding additional stimulus to the economy in the form of Quantitative Easing 2 (QE2), the market has become concerned that inflation will accelerate and potentially become problematic. If inflation picks up, bonds may not perform well relative to other alternatives.

Equities Shine in 4Q10

In 4Q10, these inflation concerns as well as improvements in economic data points forced investors to chase yield in riskier asset classes, such as emerging markets, small cap equities, and commodities. Positive economic data points like employment, Purchasing Managers Index (PMI) and GDP growth encouraged investors to move money to the equity market. As a consequence, equities had a strong fourth quarter: the S&P 500 was up 9.98% in the fourth quarter which comprised most of the index's annual return. Equity fund net inflows averaged \$3.5 billion over the four weeks ending Wednesday, December 15th, 2010 – a reversal from the steady outflows earlier in 2010. Money rotating to equities out of fixed income creates an excess supply of bonds and puts downward pressure on bond prices.

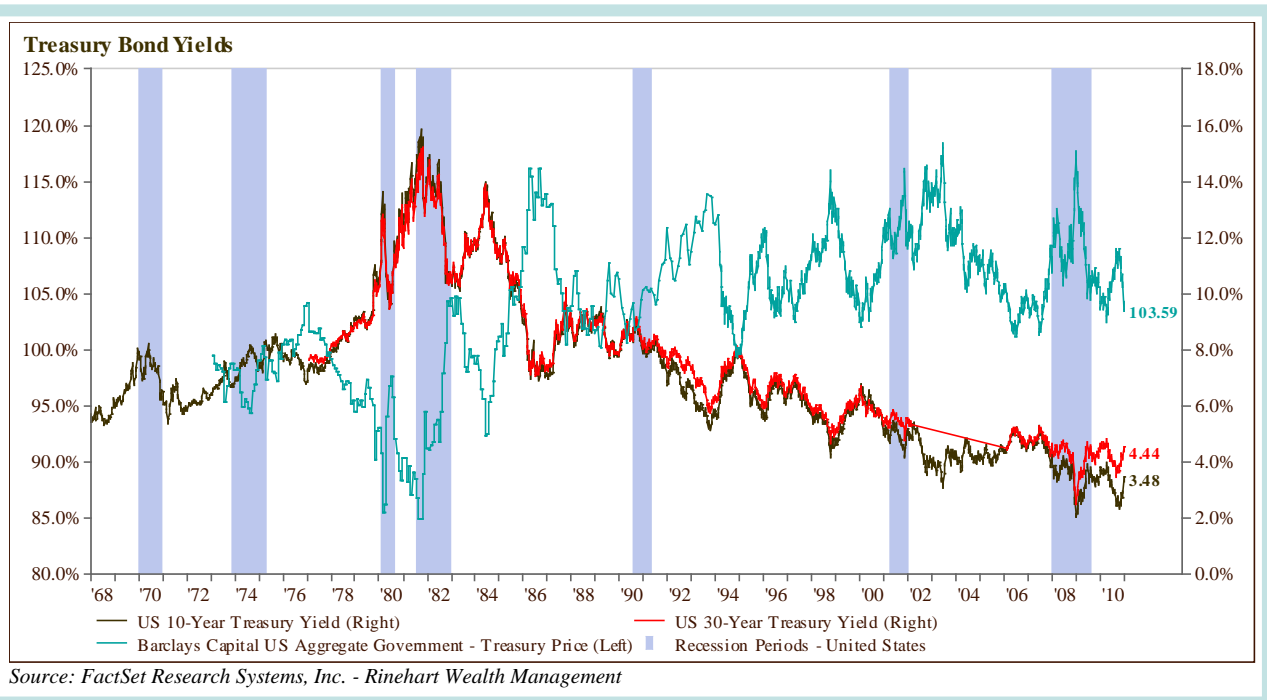
Bond Bubble

After the collapse of the equity market in late 2008, investors fled the equity market and rushed into cash, as depicted by the blue line in the chart below. As interest rates fell and bond prices rose, investors rotated aggressively into bonds in an attempt to garner some yield and mitigate volatility, as depicted by the subsequent climb in the red line below. Over the course of this time, there were massive outflows from equity investments (brown line below). This equity exodus suggests that investors may have allowed asset allocations to become aggressively skewed toward bonds, which created an “overbought” situation. Even with recent inflows to equity, retail investors remain significantly underweight equity relative to fixed income. There is still a considerable amount of money that could rotate from bonds to equities which could remain a headwind to the bond market.



Don't Abandon Your Bonds

At Rinehart Wealth Management, we adhere to an asset allocation strategy. We did not advise clients to enter the bond market aggressively and, consequently, our recommended asset allocations do not have unreasonable exposure to the aforementioned risks that are affecting the bond market. Bonds still offer lower volatility as an asset class relative to equities and the movement in bond prices is much more gradual and steady than that of equities. You can see in the chart below that it takes years for bond prices to move to aggressive levels. Given where rates are and the headwinds facing bonds, we do not anticipate they will outperform other asset classes; however, we do believe they will continue to anchor your portfolio and provide a necessary buffer during volatile times. Lest we forget the lesson learned in 2008, that equities can go down 30%+ over the course of a few months.



Regards,

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