

Bond Defaults? Responses to Questions from a Financial Advisor

Ciao Hildy, and many thanks for your message and for the preface of your new book. You must know that, in at least 15 years the average portfolio composition of my clients is between 100% bonds and 75% bonds/25% stocks...and I think that bonds are very useful for financial planning because of they can grant an established cash flow and the liquidation of the principal at an established date (if there is not a default of the issuer) ...this demonstrates, I believe, that I agree with your vision ...but I have some questions, doubts and thoughts now.

In the preface you mention insolvency (like Fannie Mae and so on) so the first question is: which are the good bonds? *The U.S. government stood behind Fannie Mae. They had a moral obligation to do so. They may not do so in the future and are considering changing the status of Fannie and Freddie.*

Maybe you know that many government bonds issued by European governments (Greece, Portugal, Spain, Ireland ...and now Italy as well) are under pressure: The question is, can we say that government bonds are a safe investment? *Government bonds are as safe as the populace's willingness to pay. Some countries, like Argentina, have shown a repeated willingness to default. If there is not a pattern of being willing to pay, then there is a good likelihood that they will not pay. Some government bonds are safe. The ratings AND the market tell you which ones are and are not.*

For sure you know that there are some "rumors" about the USA public debt: The question is, can we say that USA government bonds are a safe investment? *The yields on the USA debt tells you that despite our budget problems, the world's bond buyers say USA debt is safe. I concur. It is also possible that at some point in our future inflation could erode the value of this debt. The best protection against inflation, we believe, is to have a bond ladder, so that principal is always being returned to you, and to purchase bonds with a high coupon, so you have income to reinvest. We believe that inflation is the upside case for bond investors because you can income average up by investing in higher yielding bonds. This is contrary to what the media reports. If you are a buy and hold investor in individual bonds (not bond funds) then you will get your money back when the bonds come due.*

Do you think that corporate bonds can be safer than government bonds? *Some corporations are better run than governments. Microsoft, for example, trades very well. I would buy their bonds clearly. However, corporations are exposed to raiders and corporate takeovers. Therefore, I would not purchase long term debt of most corporations.*

Do you think that if a country goes in default that the local banks might not have the same outcome? *The two events are not necessarily firmly linked. A country may decide to default on its debt but shore up the banks in order to protect the local economy. Country default is a decision that the politicians make.*

In my mind, when a bond is included in a portfolio the client must think that the bond will remain in the portfolio until the expiration date (with the freedom to sell it in advance if needed,

at the market conditions, but with the awareness that if he/she wants to sell the bond in advance the price may not be below the purchase price and he/she could have a small or substantial loss) *We agree with this position. The only bonds we have sold were automotive company bonds, and we sold at a profit, though the problems of the company were already in the media.*

Maybe your book can clarify my doubts but I think that things are changing very fast so I am not so sure that an all bonds portfolio can be as safe as it was in the past and that, perhaps, a diversification is more needed than in the past. *We agree and believe that portfolios should be more diversified. However, we do not agree with many pundits that it is therefore a good idea to diversify into low quality, untested issuers. We do not believe in diversification for its own sake because the markets are much more correlated than they ever have been in the past.*

There are now Build America Bonds (BABs). These are bonds issued by U.S. municipalities. Most of them are highly rated and issued by high quality issuers. Though state budget difficulties have been in the press, the states in general have been taking the necessary steps to improve their financial positions. We are avid buyers of municipal bonds, both taxable and tax-free.

Hildy

[Bonds: The Unbeaten Path to Secure Investment Growth](#)

Exposes the myth of stocks superior performance and proposes an all-bond portfolio as a sure-footed strategy that can ensure results.



Hildy Richelson, Ph.D.
Scarsdale Investment Group, Ltd.

340 Miles Drive
Blue Bell, PA 19422-3100
Tel: 215-646-7693
Fax: 215-540-0272

www.AllBondPortfolios.com