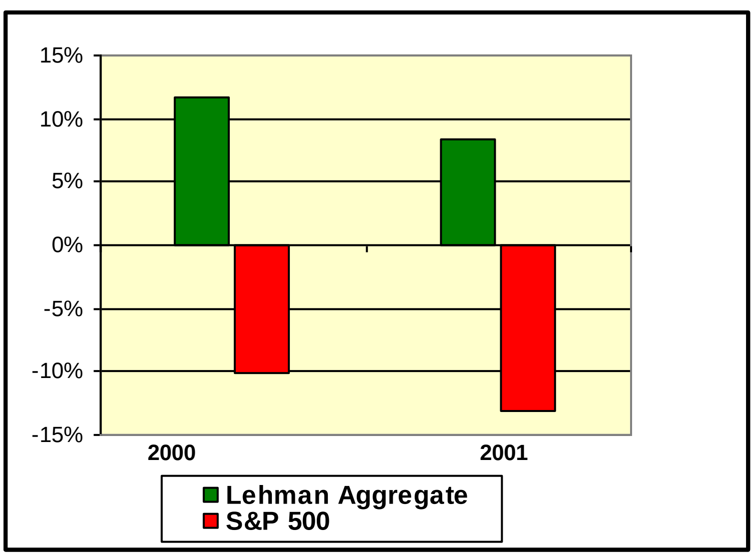
Emad A. Zikry, President and Chief Executive Officer

Bonds: Not Boring, Beautiful

Cocktail parties always bring about an interesting experience for me and for people who do what I do. I'm a bond guy, and have been one for more than a quarter of a century. The interesting experience is what I call the "empty glass phenomenon". "Empty glass phenomenon" tends to happen at functions where I know next to no one. I may have met them at last year's iteration of this year's party, but neither they, nor I, were sufficiently witty or charming to be remembered by the other. This allows each of us to re-ask the same questions asked last year. And being good Americans we get right to the point, and ask, "What do you do for a living?" My usual answer is "I am an investment manager." Up to this point all is well. The next question is usually "What do you think the stock market will do next year?" I answer "Well, actually I work in fixed income." My answer causes the near instant evaporation of whatever beverage is in the other person's glass, and requires his hasty retreat in search of a refill. Thus the name "empty glass phenomenon."

Aside from the fact that much of the language of the fixed income business is arcane and about as comprehensible to the layman as a doctor's handwritten prescription, why is it that the mere mention of it sends folks scurrying off to parts unknown? Maybe because it seems irrelevant. Why does it seem irrelevant? Because we all know that stocks outperform bonds – right? Wrong. As the chart below indicates for the past two years it has been bonds that have won the performance derby.



Fortunately portfolio management does not require that the choice be *either/or*. In fact diversification, which is arguably the most fundamental concept in portfolio management, virtually requires that the choice instead be *both*. The reason to choose *both* is, in a sense, related to the "empty glass phenomenon." Bonds are different than stocks, and they behave that way. The table below relates some of that difference.

Bonds have done comparatively well when stocks haven't

Stocks		Bonds
(29.2)%	Dec 68 - Jun 70	2.2%
(42.7)	Jan 73 - Sep 74	4.6
(14.2)	Jan 77 - Feb 78	1.5
(17.2)	Dec 80 - Jul 82	21.7
(29.6)	Sep 87 - Nov 87	2.3
(14.7)	Jun 90 - Oct 90	5.2
(13.4)	May 98 - Aug 98	4.7
(29.2)	Apr 00 - Sep 01	20.4

Source: CRSP, Standard & Poor's and Bernstein

During the eight bear equity markets that have occurred in the past forty years, bonds registered positive returns in each period. Diversification allows each asset class to help offset the other. This results in a significant reduction in overall risk for a small give-up of return. In other words, *both* are better than *each*.

Naturally the holding period, both its' length and its' place in the economic continuum, will have a significant impact on returns. In periods where inflation consistently exceeds expectations, bonds with their fixed payments will do less well, or even downright badly. Conversely, when inflation consistently falls below expectations bonds do well, often, as we have seen in the last two years, very well.

But what if we look at a longer time frame, because everyone knows stocks are a dead sure lock to murder bond performance over fifteen to twenty-year periods, right? As the Hertz commercial says, "Not exactly." In his book *Stocks for the Long Run* Jeremy Siegal examines stock and bond returns during the 150 years between 1800 and 1950.

What is interesting is that his research shows that bonds provided positive nominal returns much more frequently than stocks. And in fact, stocks only outperformed bonds in 57% of the 150 years. These are not the kind of numbers upon which most folks would bet the farm. Once again, the point here is not to argue the case for one asset class to displace the other in anyone's portfolio. The point is that this is a case where the cliched word "synergy" is apt. In portfolio management the whole can be worth more than the sum of its' parts.

So you see bonds may not be as sexy as stocks, but they are beautiful in their own right. So perhaps when we meet at some elegant soiree the zephyr that dries up your libation will not be as strong, we can have a pleasant chat and you may even come to appreciate, as I do, that bonds are indeed beautiful.

Odds and Ends

I'm not sure where the Fed Governors may look, but the only inflation that is currently obvious to me is grade inflation at Harvard and other institutions of higher earning…oops, I meant *learning*.

"If it is not excessive, a national debt will be a national blessing." Alexander Hamilton was a smart guy (with the exception of that regrettable morning on the Jersey palisades) and this quote bears pondering.

This month's nickname challenge is: "What were Canadian Pacific Perpetual Consolidated 4% Debentures called?" The "4's of forever."

If bonds keep outperforming stocks as they have for the past two years, we bond geeks may start to lobby to have asset allocation ratios quoted with the bond component first. "40/60" bonds-to-stocks has a nice ring to it, doesn't it?

Vanderbilt Research Team