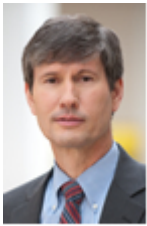


# Vanguard's investment chief cautions bond investors

- November 22, 2010

Bonds have been on a roll, with double-digit returns posted by several fixed income categories this year. Such a winning streak may tempt you to think you've got a free lunch: return with no risk.



Gus Sauter

That's hardly the case.

Vanguard believes bonds and bond funds can play a valuable role in nearly any investor's portfolio. At the same time, we also believe it's important to have a balanced perspective and keep your eyes open to risks.

Chief Investment Officer Gus Sauter spoke with Vanguard.com about his outlook for the bond market and why you should have tempered expectations.

## What's your main concern right now?

I'm increasingly worried that people aren't aware of the risks in the bond market. We have very low interest rate levels. But at some point, the economy will strengthen and those interest rates will rebound. Investors who have pushed out further on the yield curve by investing in longer-term bonds will then see a greater decline in the principal value of their investments.

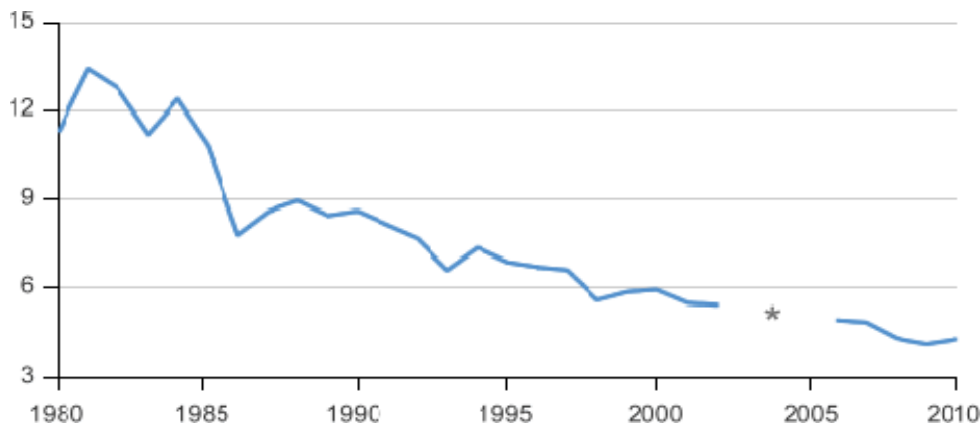
When you're seeking yield by moving into longer-term bonds, you're exposing yourself to greater fluctuations in principal. Those fluctuations are likely to be negative at some point in the future, and they'll be negative by a greater magnitude for longer-term bonds than for shorter-term bonds.

That certainly doesn't mean you should avoid a sensible allocation to bonds; it just means you need to be aware of the risks. Bonds are still attractive from the standpoint of providing diversification. They can reduce the volatility of your overall portfolio. But they're also likely to provide more modest returns going forward than we've experienced in the recent past.

## Why do you expect modest returns?

There are generally two components to bond returns. One is the yield, but then there's also the principal appreciation or depreciation when the yield changes. So when the yield's declining, as it has over the last almost 30 years, the return from a bond fund, and bonds in general, has been aided by that reduction in interest rates and increase in principal. You've gotten a nice yield and at the same time a boost from principal appreciation.

## A 30-year fall for the 30-year yield



The yield for the 30-year U.S. Treasury bond generally has declined since the early 1980s. Note that there is no data for yield for 2003, 2004, and 2005 because the U.S. Treasury had suspended issuing 30-year bonds during those years. Source: Federal Reserve Board.

The problem is that when you're at historically low rates, as we are now, you're not likely to get much more principal appreciation. In other words, yields aren't likely to go significantly lower, and at some point when the economy does strengthen, they're likely to push higher. When that happens, you'll actually have principal depreciation that will at least partially, and perhaps entirely, offset some of your yield. And we know that the yield component itself is less than it has been over the last 30 years.

### Some commentators have warned of a "bond bubble." What's your view?

It's hard to define exactly what a bubble is. We wouldn't expect bonds to suffer the types of declines we saw in stocks in 2008. But we think the prospects for bonds are muted relative to what we've experienced recently because of where we are.

When interest rates do start to push higher, the big question is how fast they'll move up. If rates move sharply, we could experience a year or more where investors receive a meaningfully negative total return from bonds. That's certainly happened in the past. And it's very possible, if not probable, at some point in the future.

But the silver lining to this scenario is that you'll be earning a higher yield. You'll have some reduced principal, but you'll be earning that lost principal back through a higher yield. There will be years that are very disappointing, but over the longer term, such as a 10-year time frame, we think the average annual rate of return for the broad U.S. bond market will be about 3%. (Mr. Sauter's forecast is based on long-term projections that were generated by the Vanguard Capital Markets Model®, a proprietary financial simulation tool used in Vanguard's investment methodology and portfolio-construction process. See the notes below for more information.)

### Treasury Inflation-Protected Securities (TIPS) have gotten a lot of attention recently. What should investors with those types of bonds be aware of?

With a TIPS investment, there are three components of return: the real return, the inflation principal adjustment that you receive, and the principal appreciation or depreciation associated with changes in the real return.

The real return has declined quite dramatically over the last year, and even the past several years, to the point where a recent auction on a 5-year TIPS bond had a real return of  $-0.55\%$ . Historically, the average real return has been roughly anywhere from 2% to 3%. The decline in real returns in recent years has boosted the overall return of TIPS, because of the increase in principal value.

## TIPS and conventional Treasuries in various scenarios based on historical performance

Inflation scenarios	Expected performance
Lower-than-expected inflation (Positive inflation surprise)	Total return of conventional bonds should outpace return of TIPS.
Inflation as expected (No inflation surprise)	The relative performance of conventional bonds and TIPS bonds remains fairly constant.*
Higher-than-expected inflation (Negative inflation surprise)	Conventional bonds should perform worse than TIPS.

\* In the long run, returns of conventional bonds should surpass the returns of TIPS by an amount equal to the cost of the inflation risk premium. In effect, investors in conventional bonds would be rewarded for shouldering uncertainty regarding the future rate of inflation.

Source: Vanguard.

Technically, the inflation adjustment is not paid in the form of a larger income distribution. It is paid in the form of an adjustment to the principal of the bond. This process ensures that the principal will increase with inflation and the real rate of return will be paid on a larger amount of principal so that the income distribution also grows with inflation. As the economy does start to strengthen and associated inflation starts to pick up, you'll get that inflation contribution, but it could be partially or entirely offset by a principal decline if real rates go higher. You'll have a decline in your principal the same way you do when rates go higher for a traditional bond.

Once real rates have gone back to a long-term historical level, then you'll receive that real rate plus the inflation adjustment. So longer term, TIPS are a good source of protection against unexpected inflation. But in the near term, there may be some principal decline associated with providing that inflation hedge.

### How should an individual investor respond to what's happening in the bond market today?

Each investment plays an important role in an overall portfolio. Generally speaking, stocks are there for higher expected returns; bonds are there to moderate the volatility associated with those higher expected returns; and some investments, such as money markets, are there mainly to provide liquidity. So each component has a specific role in your portfolio and that doesn't change much over time.

Even though interest rates are low and return expectations are modest, investors should think about bonds the way they always have: The role of bonds in a portfolio is to provide stability and reduce volatility with a reasonable rate of return. Look at your long-term plans—what it is that you're investing for and saving for—and [build your asset allocation](#) around that. That includes a [broadly diversified portfolio](#) of stocks, bonds, cash, and, perhaps, some other complementary investments. I would also say that it's very important to have rational expectations for returns for those investments.

### What's the advantage of having a long-term plan for asset allocation?

It keeps you focused on the future, not the past. Frequently, investors project the past into the future. We've had very high bond returns over the last several years, but it would be a mistake to project those into the future. Similarly, stocks have provided virtually no return for the past decade, and it would be a mistake to project that into the future.

Sticking with a long-term asset allocation keeps you from chasing past returns, which can lead to big disappointments. At some point, hot investments have historically reverted back to normal and the best performers sometimes became the worst performers. A classic example is internet stocks of the 1990s into 2000. But it can happen with all asset classes.

Having a long-term plan and rational expectations for investment returns should help prevent you from overreacting to the past. It makes it less likely that you'll be subject to emotion and react in a knee-jerk fashion.

**Notes:**

- *Important: The projections or other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time.*
- The VCMM is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the VCMM is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. During the ten years ended December 31, 2009, the broad taxable U.S. bond market returned an average of 6.3% per year. That was higher than its longer-term average of 5.5%, dating back to 1926 (according to Standard & Poor's, Citigroup, and Barclays Capital). The median annualized total return for the next ten years through 2020 is projected to be lower than both figures. Again, there are many potential outcomes for bond returns. In Vanguard's analysis, the lowest 10% of projected return possibilities are still positive.
- All investments are subject to risks. Investments in bonds and bond funds are subject to interest rate, credit, and inflation risk.
- Diversification does not ensure a profit or protect against a loss in a declining market.
- *An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1 per share, it is possible to lose money by investing in such a fund.*
- Past performance is not a guarantee of future results.