



## **Bonds 2.0**

*Bonds go real time, real diverse, real easy*

For decades, many would-be bond investors have been on the outside looking in, forbidden or discouraged from many segments of the market. That was then. Today, indexing via exchange-traded funds (ETFs) is rewriting the rules for bonds like it has for stocks – providing new protection, universal access, better information, and lower costs. Is your portfolio keeping pace with these dramatic changes and opportunities?

### **A fresh look for bonds**

Not even the savviest investors owned the following bond indexes 10 or 20 years ago. They didn't exist. Only in the last few years have individual investors had the opportunity to build a portfolio of deeply diverse, tax-efficient and risk-sorted bond index exchange-traded funds. Consider some of the bond ETFs now available:

- **BWX** (debut 2007) – To create a diverse portfolio of sovereign non-US bonds – thereby benefiting from a weak dollar – once necessitated a portfolio with at least \$100 million, a lot of time, and insider contacts. Bonds in this market trade in \$5 million lots, and one would need to include the UK, Germany, France, and Japan to even begin to diversify. This once pro-only arena is now open to all.
- **MUB** and **TFI** (2007) – These municipal bond ETFs provide the traditional benefits of municipal bonds, but in a diverse index format likely to be less risky than owning any single issue.
- **WIP** (2008) – This non-dollar inflation-linked index ETF protects against both a weak dollar and international inflation, through global government and agency bonds.
- **PCY** (2007) - The Emerging Market Sovereign Debt ETF offers access to a bond world where most of the world's people live and where there are huge sovereign reserves of US debt (Russia, for instance, owns \$60 billion US Treasuries, and Korea \$40 billion). (<http://www.treas.gov/tic/mfh.txt>)
- **TIP** (2003) – This vehicle combats one of the natural enemies of bonds – inflation – by indexing US inflation-linked bonds.

You get the idea. Bonds 2.0 is all about fair and democratic access to the entire spectrum of debt securities – areas that were previously off limits to individual investors or did not even exist. We see this as an important resource that can help investors enhance their portfolio composition, in the same way that the availability of hundreds of low cost, tax-efficient stock ETFs has transformed equity investing.

In our view, investors can – and should – seek to create bond portfolios that mirror the diversity of the entire debt universe. Our bond portfolios generate tax-free and taxable income, include a range of maturities and geographies, and are structured to be adaptive to changes in dollar purchasing power and inflation. In fact, OCM bond



portfolios contain six different types of bonds: municipal, Treasury, non-US sovereign, non-US emerging markets sovereign, TIPS, and non-US TIPS, all in index ETF form. (We never recommend corporate bonds, however.)

### **Transparency at last**

Why now? What inspired the Bonds 2.0 world? A quick history lesson. The changes began in 2002 with TRACE, a then little-known SEC-endorsed system that created the first publicly reported information clearinghouse for bonds. All trades had to be fully reported within 15 minutes of execution. TRACE propelled bond investing into the modern age. At last there was a means to make sense of the tens of thousands of diverse bonds traded privately in over-the-counter markets. The thick curtain around the industry fell to the ground.

Once all bond transaction details were available in TRACE, a funny thing happened. Bond trading profits fell. When publicly reported pricing replaced undisclosed spreads, investors could shop for the best price, and the margins available to middlemen were driven down by competition and the scrutiny of the marketplace. Even recently, it is estimated that bond dealer profits alone shrank by \$1 billion in 2007, and that trader employment has fallen by one-third.

Fair and transparent pricing is a key ingredient in indexing. And sure enough, the first bond ETF – Barclay’s Lehman Aggregate Bond Fund (AGG) – followed on the heels of TRACE, arriving in September of 2003. Now there are more than 50 bond ETFs.

We take exchange-traded funds (ETFs) for granted today, but remember that it all started with a single issue when the first stock ETF – the S&P 500 index, SPY – debuted in 1993. Fifteen years later, the stock ETF market includes hundreds of options and more than \$600 billion in assets. The same pebble has been thrown into the bond pond, with the impact quickly spreading.

### **Zigging while others zag**

Given the diversity of stock ETFs, why is it so important to hold bonds? Bond indexes offer an important balance to even the most diverse equity portfolio. Mixing investments with low correlations can help investors improve their opportunity for positive performance (higher return, lower risk) regardless of market conditions. This is modern portfolio theory (MPT) in a nutshell. Harry Markowitz won the Nobel Prize in economics for his 1952 paper on the subject in the *Journal of Finance*. His actual thesis is tough reading, but it works, and has gone from stone-tablet status to real time application in the last generation. Many endowments now live by MPT.

Markowitz might use today’s markets as a case in point for his thesis. It is easy to think of the recent market performance as a discouraging backslide, but that’s only true if you are holding investments that are highly correlated and all moving down at once. In truth, bonds are enjoying a strong rally. For instance, State Street’s WIP International TIPS returned 21% between March 2007 and February 2008, versus



-3.6 for the S&P 500. State Street measures the correlation between the two indices at .01 during the same time frame – essentially none. (Statistics from ETFcommentary.com) In the right proportion, WIP can be a powerful team member in any portfolio, a refreshing zig when other investments zag.

### **Would you loan your governor \$1 million?**

Here's another reason to own bond ETFs. When you buy municipal bonds, you are lending money to your governor, mayor, or other elected officials. This may or may not be a good idea, but it is easy to see that if you are loaning money to politicians it is more attractive and prudent to loan to fifty states worth of them at once in small amounts than to any single government entity in one large lump. The natural diversification of ETFs makes that a simple one step purchase.

This is the elegance of indexing – you do not need to research and choose among hundreds or thousands of individual securities. By buying a category, you reap the total return of the category. This may sound like settling for average, but it turns out that attaining the average actually means performing well above average. This isn't doubletalk.

#### **The OCM Advantage:**

Osbon Capital Management utilizes up to 6 types of bonds in client portfolios, selected for their income potential, low correlation to equities, tax-efficiency, historical low costs and ability to protect against domestic inflation and fluctuations in the value of the dollar

According to a May 31, 2008 Wall Street Journal article, "Though Stock Pickers Struggle, Tech Shares Revive" by Diya Gullapalli, the Vanguard Total Stock Market Index was ahead of about 60% of actively managed funds through April. This is not a new phenomenon. Only 22% of actively managed mutual funds beat the Vanguard 500 Index Fund over the 20-year period spanning the 80's and 90's. After considering the impact of taxes, only 14% outperformed the index. (From Yale endowment manager David Swensen's book, *Unconventional Success*). That means index investors, mirroring the performance of the S&P 500, would fall in the top quintile of investment managers. Average is above average.

Average has been above average for equity indexes, and I personally believe the same will be true for bond ETFs. And for the same reasons – low costs, limited turnover and no severe management fees.

### **The ripple is a wave**

It has taken since 2002, but one can now genuinely index a global bond portfolio. With TRACE-inspired transparency and the access and price efficiency afforded by ETFs, the bond markets have never been more democratic and rational. Bond ETFs now exceed \$50 billion, and offer access to the \$1.7 trillion municipal market, the \$5.1 trillion Treasury debt market, and other large, liquid bond markets. These institutional markets were previously off limits or disadvantageously priced to individuals, but now with bond ETFs, institutional structure works for, not against individual investors. Welcome to Bonds 2.0 and all the possibilities that come with it.



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