HUTCHINSON
CAPITAL
MANAGEMENT

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INVESTMENT PERSPECTIVES

Bonds for All Seasons

Traditionally, high quality bonds are viewed as a safe place to invest. In fact, prior to the late 1920s most individuals invested in bonds and not in stocks. The shift to investing increasingly higher percentages of a portfolio into stocks versus bonds became the norm from the early 1950's until the end of last year largely because of the higher total returns that investors grew to expect from stocks (8%-10% per year) versus bonds (4% to 5% per year). We now are seeing a resurgence of interest in investing in bonds because the S&P 500 Index (a standard measure of stock performance) has delivered an annual compound rate of return of negative 3.15% per year since December 31, 1999 while the Barclays Capital U.S. Aggregate Bond Index has delivered an annual compound rate of return of 6.03% in the same time period!

During this same time frame our clients' stock returns have been a positive 4.08%, our fixed income returns have been 5.29%, and total returns have been 4.88%. (NOTE: These percent returns are for our clients' Non-Taxable Balanced portfolios). We would like to reaffirm our strong conviction that owning some bonds makes sense for most clients. We still believe that stocks will offer a higher annualized return over longer time periods (five years or longer) so a significant shift to more bonds does not make sense for most of our clients.

The Appeal of Bonds

- A bond is a loan – the issuer (a company or government) is the borrower, the investor is the lender. For example, on a home, you are the issuer of your mortgage and the bank or other holder of your mortgage is the lender.

- The issuer borrows a certain sum (the face amount of the bond) for a certain period of time at a fixed rate of interest (the coupon rate). At the end of that period the bond matures and the borrower repays the investor the face value of the bond.

- Bond returns come from two places, the coupon rate and the return from capital gains or losses incurred if the bond is sold before it matures. Together they make up the bond's total return which is called the yield to maturity. This is the total return over the life of the bond, stated on an annual basis.

We believe that high-quality investment-grade bonds are an important part of any portfolio. Bonds are a stabilizing influence, often increasing in value when stocks decline in value. This is a major reason why most of our clients' portfolios do not decline as much as the overall stock market during a bear market.

Bond appreciation occurs for two basic reasons. First, bond prices move in the opposite direction of interest rates. For example, a bond that pays a 5.0% coupon would become more valuable if market interest rates declined to 3.0%. In an economic decline, interest rates tend to fall and as a result existing bonds appreciate. Second, bonds appreciate when investors lose confidence in stocks during an economic downturn – investors tend to buy bonds instead of stocks because bonds offer a secure and attractive yield.

Additionally, bonds provide a steady source of income within a portfolio. This income stream is especially important if you are retired and may need additional income to supplement other sources of cash flow. Bonds also are the preferred source of funds should you need cash and would rather not sell a stock that has just begun to appreciate due to an improving earnings situation.

Bond Risk

- Bonds have two main types of risk:

    1. Credit Risk – This is the danger that the issuer will default on interest and/or principal payments. In general the higher the credit rating, the lower the yield and the risk. The two primary rating agencies in the U.S. are Moody's and Standard & Poor's. Bonds fall into two broad categories—investment grade (AAA, AA, A, BBB) and below-investment grade or "junk".

        We typically use the ratings agencies as a guide, but not the rule. These agencies have made egregious mistakes in the past especially in sub-prime mortgages and typically don't understand that a company's ability to repay principal and interest is dependent on a *consistency* of cash flows in both good times and bad. We would prefer to own a well-managed "BBB" rated grocery store chain like Kroger rather than Lehman Brothers (an "A" rated credit just before it went bankrupt). A grocer may have more debt, but people always need groceries.

    2. Interest Rate Risk – This is the risk that interest rates will rise after you have purchased a bond. If you hold a bond until maturity and the issuer doesn't default you will get back the face value of the bond. For example, a $100,000 bond with a 5% coupon pays the holder $5000 per year (the coupon rate and the dollar payment are fixed for the life of the bond). If interest rates rise to 10% all new bonds issued would have to yield 10% or no one would buy them – that is the new

‘going rate’. If you needed to sell your 5% coupon bond immediately, you would have to sell it with a 10% yield. The price of your bond would decrease depending on the maturity of the bond – the longer the maturity the greater the price decrease.

Many investors are currently frustrated with the yields that they are able to find on Certificates of Deposit and other cash equivalents. Since the start of the credit crunch in late 2007, the Federal Reserve Bank has decreased interest rates on short term Federal Funds to less than 1/4%. While this has been a boon for creditors and helped ease mortgage rates, it has created a serious dilemma for individual investors.

As we get closer to zero percent, people will look for alternative investments. The problem is if interest rates rise, the value of the bonds you just bought will fall (see above). In our opinion, we are currently in a situation where the Federal Reserve doesn’t have any more room to lower interest rates and at some point will need to raise rates to offset any inflation that creeps into the economy.

Right now the only way to get higher yields is to take on credit rate risk and/or interest rate risk. In today’s environment, in our opinion, you should assume a minimal degree of either one of these risks – it is not worth chasing yield while risking some or all of your principal. Warren Buffet’s comment is quite apropos: “It’s like picking up nickels in front of a steamroller”. We are strong believers in not risking your entire investment to earn a slightly higher yield!

Our best advice is to always stick with quality. Quality bonds with one to six year maturities are more likely to return your entire investment at maturity and provide you with steady income over the term of the bond.

Bond Strategies

We use the following strategies when buying bonds:

Ladder – Our strategy is to buy bonds in equal dollar amounts for each of the next six years. Currently, this would be from 2010 through 2015. This ensures that a portfolio does not hold a large quantity of bonds that would reach maturity at the same time and eliminates the possibility of having to reinvest a large amount of cash at low interest rates.

Our strategy over the past several years has been to shorten our bond ladder from ten years to six years. One reason for shortening our bond ladder is the lack of return available from longer-maturity bonds; the other reason is our growing concern about rising inflation and its impact on interest rates in general. The compression of the bond ladder also shortens the duration (average amount of time it takes to recover both your interest and principal on your bond portfolio) of your portfolio to approximately 3.25 years.

Tax Considerations – We have a matrix that identifies the most appropriate bond for your portfolio based on your tax bracket and the year of bond maturity. There are three types of bonds that we buy:

- Corporate Bonds – These bonds carry higher effective interest rates than other types of bonds, but are taxed at both the federal and state levels. Generally, these are not appropriate for our clients in the highest tax brackets.

- U. S. Government Bonds and U. S. Government Agency Bonds – These bonds have interest rates between corporate and municipal rates – a few of these bonds are taxed by the federal government but not by state governments.

- Municipal Bonds – These bonds are issued by individual states, municipalities, and special districts and are free of both federal and state income taxes on bonds issued by the state where you reside. They are generally appropriate for clients in the higher tax brackets.

We continually review the quality of our bond holdings. Occasionally, based on a variety of factors, the quality of a bond may deteriorate and we may sell them; however, this is rare.

Summary

Through all seasons we have found it appropriate (actually, necessary) to invest in high quality bonds. As we have discussed, bonds provide a safety net during turbulent times while providing a stream of income in more docile periods.

Our approach is to invest in high-quality bonds and to avoid the risk associated with high yield bonds (normally referred to as junk bonds). Investing in high quality bonds provides a steady stream of income while preserving capital. Along with our investments in value-oriented stocks, we believe that your assets will be protected over time while yielding reasonable returns.

HCM’s investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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