

# Bond managers: Check your assumptions

*If 15th century scientists had been right in their assumptions, Columbus would have sailed off the edge of the earth. Bond managers use assumptions that may be just as false — and as misleading — as the flat earth hypothesis.*

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In the January 1995 *Wall Street Journal* survey of leading economists' interest rate predictions, the consensus opinion had 30-year Treasury bond rates rising slightly from 7.87% to 7.94% at mid-year before backing off to 7.51% at year end. At Dec. 31, 1995, the long bond was trading at 5.95%. The experts said north, but rates went south.

On April 3, 1995, Standard & Poor's issued a creditwire release stating "Standard & Poor's places its B

rating of Continental Medical System Inc. Subordinated Debt on credit watch with negative implications." The release explains, "the negative implications reflect Horizon Healthcare Corp.'s proposed merger offer for Continental Medical in a stock transaction valued at about \$500 million." On the same day, at about the same time, Moody's Investor Service issued a statement that "Moody's reviews B2 senior subordinated ratings of Continental Medical Systems Inc. with direction uncertain."

When a bond is earmarked for potential downgrade in rating, investors usually rush to sell and the bond price plummets. However, a check of the market indicates that the bonds involved had appreciated significantly following the merger. Prior to the merger announcement, Continental Medical's subordinated debt had been trading in the mid \$80s, but now was trading at prices above \$100. How is it possible for the rating agency experts to differ so widely from the market's opinion

of the implications of this merger?

Obviously, the experts aren't right all the time. Recent examples illustrate the weakness of fixed-income management approaches that rely on interest rate forecasts and rating agency opinions.

In the eyes of the average investor, management of bond portfolios is straightforward. Most people understand that bonds move inversely to changes in interest rates. Usually they assume the principal differentiation between the bonds of various issuers is based on the rating bestowed by Moody's or S&P's rating services. Thus, two simple rules seem to cover the bond management effort:

□ If you think interest rates are going up, buy only short-term bonds; if rates are predicted to fall, buy longer maturities to lock in yields and achieve capital gains on the bonds.

□ You can control the risk in your bond portfolio by setting minimum

quality rating restrictions on the portfolio holdings, ensuring portfolio safety.

Managing fixed-income portfolios with these rules has apparent logic. In fact, many professional bond managers embrace this approach, and many investors assume this is the only approach to fixed-income management. Yet there are demonstrable, serious problems with both of these rules that can lead to underperformance in bond portfolios.

What is the problem? Logical systems that generate illogical results usually share one important flaw: The systems are based on false premises. Scientists and navigators in the 15th century predicted that Columbus would sail off the edge of the earth, and they would have been right if their premise of a flat earth was correct. Bond managers using the rules discussed previously have their

own "flat earth" problem. These rules are based on two important, but false, assumptions:

□ A manager can predict changes in interest rates consistently; and,  
□ Bond ratings properly assess risk in individual bonds, and the differentials in returns among bonds are explained by differences in ratings.

Some embrace a bond management philosophy that avoids these widely accepted but false premises. Before reviewing that philosophy, the past evidence on interest rate predictions and bond ratings may offer perspective.

## Interest rate predictions

Someone once asked prominent economist John

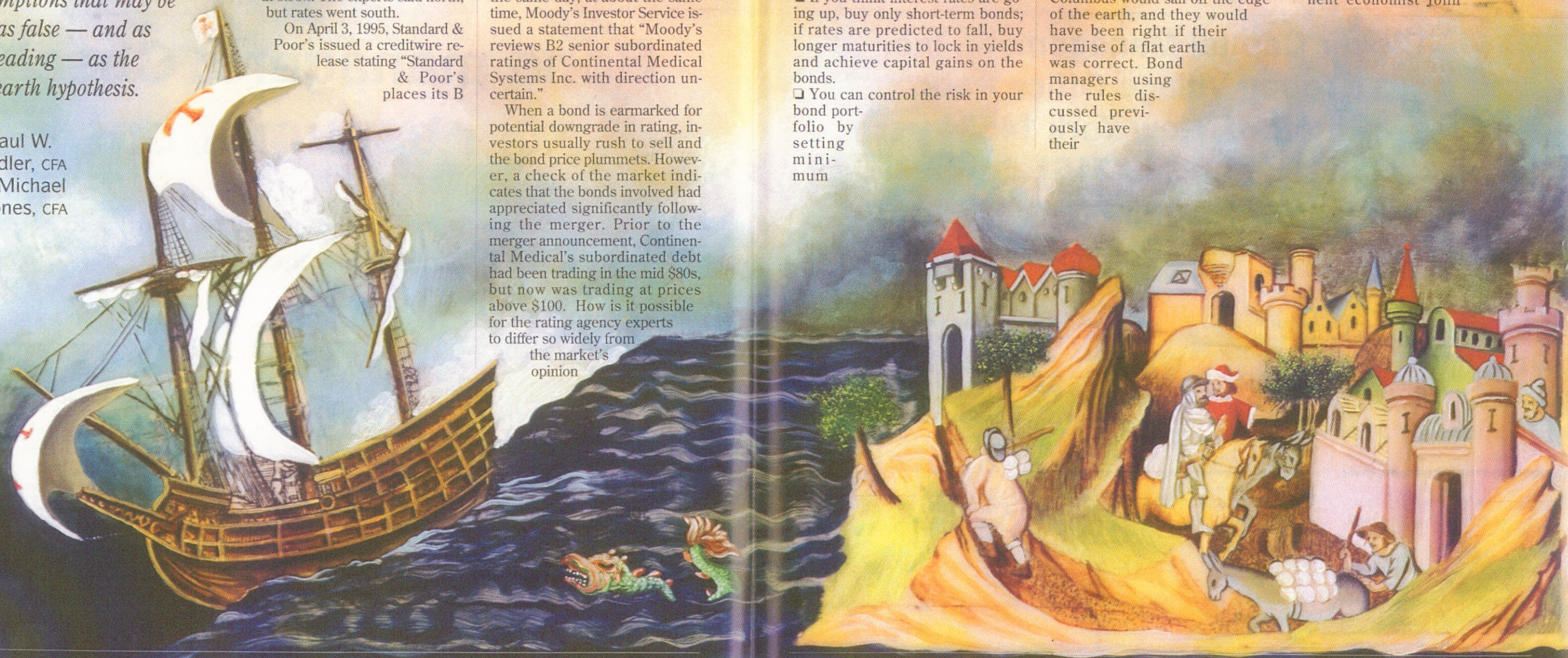


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