ADVISOR PERSPECTIVES

Dan Fuss: The 50-Year Opportunity in Bonds

By Susan B. Weiner, CFA
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Opportunities in the bond market are as attractive now as they have been in at least 50 years, according to Dan Fuss, vice chairman of Loomis, Sayles & Company. He spoke on “The Bond Market Outlook” to the Boston Security Analysts Society on November 24. Fuss co-manages numerous institutional accounts, the Loomis Sayles Bond Fund, and the Loomis Sayles Strategic Income Fund.

Treasuries overvalued, investment-grade and high-yield attractive

Investors around the world are still rushing into U.S. Treasuries, but Fuss has already hit the exit. He sold his remaining Treasuries on Nov. 20. “They were vastly overpriced,” he said. Investors’ appetite for Treasuries is “very understandable for liquidity,” but does not make sense based on current valuations. The long-term outlook for government bonds isn’t good because governments — not just the U.S., but also countries like Japan and Germany — will be big issuers of new bonds.

But Fuss sees opportunities in investment-grade corporate bonds. Even if defaults and losses rise as high as in the Great Depression, Fuss said, these bonds “are very cheap.” In addition, he said, convexity is “wonderful,” and reinvestment risk is low. Convexity measures the extent to which upside and downside responses to interest rates are different -- a highly convex bond will act like a long duration bond when rates fall (a good thing) and like a short duration bond when rates rise (also a good thing) -- hence convexity is a very desirable property in a bond.

“I’ve never seen an opportunity — relative or absolute — as good as this to buy in the investment-grade market,” he said.

Fuss also likes high-yield bonds. They also seem cheap, even if defaults and losses hit Great Depression levels, although such historical analyses must rely on proxies since high-yield bonds didn’t exist back then. However, unlike investment-grade corporate bonds, high-yield bonds have been this cheap before, as recently as six years ago. Still, he said, if you know what you’re doing, investing in high-yield bonds could pay off with “a small fortune” — as long as “you’re willing to take 30% bloody disasters and 70% survivors.”

"Specific risk is high, so you've got to be able to do your homework," Fuss said, adding that there's no telling how soon the bond market will recover. Indeed, Loomis Sayles' 2008 fixed income performance has suffered from betting too early on the recovery of the corporate bond market, as *Advisor Perspectives* noted in "Tantalizing Opportunities in High-Grade Bonds."

When will it end?

Right now, lack of liquidity is the big problem, Fuss said, so buyers must return for prices to recover. But most buyers feel pessimistic. "People like me say, 'Wow, look at those spreads,' … but some investors don't focus on spreads," Fuss explained. "They look at [mutual fund] NAVs." Many mutual fund investors are selling as the net asset value of their funds fall. When these investors start buying again, they could be "the biggest swing factor of all," he said.

Fuss already sees some buying of corporate bonds. Quiet yet persistent demand for long, high-quality, high-yielding corporate bonds with below-average reinvestment risk sounds to him like defined-benefit pension funds immunizing their fixed liabilities. There's also low but growing demand from institutions postponing capital expenditures. That might come, for example from a school that broke ground for a new dormitory, but then decided not to proceed right away.

Fuss is also seeing some appetite for asset-backed securities. Traditional distressed buyers "are buying to get their money working" or they'll have to give money back to their investors. In addition, some investment management firms are buying asset-backed securities.

As for the exact timing of the bond market's recovery, "I don't have the foggiest idea," Fuss said. He likes a quote by Sir John Templeton: "You buy at the point of maximum pain," but the big problem, he acknowledged, is identifying when that occurs.

Whenever that turning point happens, however, corporate bond prices may move quickly. Some investors might miss out if they take the wrong approach to tax-loss selling. The run-up in Treasuries has put bond funds in the unusual position of having capital gains, forcing them to sell to avoid tax losses. Given a choice between selling and later buying back at year-end or going from Fund A to a basically identical Fund B, Fuss prefers the latter because investors who get out of bonds for even a short period could miss out. "I say it is dangerous to take a 31-day gap," said Fuss, referring to the wait required to avoid losing the loss deduction under the Internal Revenue Service's wash sale rules. "This market could—not will, and not even probably—pop."

There could be a fast, short-lived rally in the corporate bond market. "It is so thin that if somebody out there who is immunizing $3 billion of a defined-benefit plan decides that time is running out," they will buy quickly, resulting in a price increase, with a resulting decline in yields. But then that yield decline will drive them out of the market again.

Fuss sidestepped a question about "where should high-net-worth clients invest for income?" Hang in there," he said. "It is a terrible time to sell."

Susan Weiner, CFA, is a writer specializing in investment and wealth management. Contact her through http://InvestmentWriting.com*.*