Investors Are Overweight Bonds

So says the Wall Street Journal in an article this morning announcing that *Investors See End To Bond Rally.* Of course the real problem with fixed income is not just the eventual tapering of asset purchases by the Fed, maybe sometime next year under Janet Yellen or maybe beyond that. It's that yields don't provide any return to compensate even current inflation never mind the possibility of it one day rising.

The WSJ notes that U.S. taxable bond funds currently hold $3.8 trillion. It's hard to believe but in 2000 the figure was $720 billion, so whether that counts as a bubble or not, it's certainly looks like a collective overweight to this particular asset class. And the sorry Math of fixed income is that if you hold a ten year treasury security yielding 2.7% and in a year's time ten year yields have risen to 3.1%, the loss on your holdings will offset the interest income; Total Return = 0. This is a reasonably likely prospect for trillions of dollars of invested capital. After taxes and inflation, it's a 2-3% loss in purchasing power, around $75-115 billion in losses. The math is similar for shorter maturities where yields are even lower, and owning high grade corporate bonds doesn't alter the outlook much either. So far bond returns in 2013 are an example of what investors will likely face for many years to come.

Since diversification is good, investors should diversify away from fixed income. When you hear a bond manager say they're focused on sectors of the market where prospects are better, or that bonds are still an important source of stability, run the other way. You'll be better off holding more cash than you might otherwise like, since cash has a good chance of beating bonds, and lean on the stability provided by cash to own more equities than you might otherwise. The Fed doesn't want you in fixed income.