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MENTOR CAPITAL

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Mentor Monthly Missive

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- The risk of a 'bear' bond market
- How to protect yourself from 'phishers'

Withstanding a bond 'bear market'

Bonds are an integral part of every investment portfolio. Why? They diversify the risk inherent in the equity (stock) markets. While there have been many bear stock markets (declines of 20% or more), there has never been a decline of 20% or more in the broad U.S. bond market.

But bonds do carry risks. First, there is market risk, or the risk that the bond issuer will suffer financial difficulties and that its bonds will lose value or, in the worst case, become worthless due to bankruptcy. The other is interest-rate risk, when bond values decline due to a rise of interest rates in the economy.

With interest rates at historic lows, many investors are worried about a bond bear market and what it might do to the fixed-income portion of their investment portfolio. In recent research papers, Vanguard attempted to shed some light on the situation and what investors should do now.

In the papers, Vanguard attempted to answer three important questions:

- Why are long-term U.S. interest rates, such as the 10-year Treasury yield, below 4%, given the expected future path of U.S. government debt levels and the Federal Reserve's "exit strategy?" More pointedly, don't long-term rates have to rise dramatically?
- How might bond funds perform in the event that rates do rise over the next several years?
- Is it not prudent to re-allocate one's bond portfolio defensively into shorter-maturity funds or cash before rates start rising?

To the first question, Vanguard offered this assessment: "The expected upward pressure from the fiscal deficit on long bond rates has been offset so far by increased bond demand arising from a higher domestic savings rate."

As to how bond funds might perform as rates rise, Vanguard said that it's an unknown. "History suggests that rates will likely evolve quite differently from what is expected today, as the forecasting track record of the futures market is notoriously poor," Vanguard said.

How about shortening duration or moving into cash, in the face of a rising-rate environment? "There are several potential concerns with such a strategy," Vanguard said. "Davis et al. (2010) note the risks inherent in such a strategy if the yield curve experiences a 'bear flattening,' meaning short-term rates rise, while longer-term rates remain anchored. In addition, investors who shift from bonds to cash will realize an opportunity cost in the form of lower yield while they wait for the anticipated rise in rates. The longer the wait, the greater the yield give-up.

"Finally, because cash has historically offered a meager real return, investors using such a strategy would then need to correctly time their exit. This is because, historically, cash investments have tended to underperform both stocks and bonds following a given rise in interest rates in both nominal and real returns.

“For example… using the returns for the Citigroup 3-Month Treasury Bill Index, we found that cash investments registered an average nominal return of 12.1% (5.3% average real return) compared with Treasury bonds’ average nominal return of 16.6% (9.9% average real return) and equities’ average nominal return of 12.5% (5.8% average real return) during the 12 months following a 200-basis-point increase in long-term interest rates. For changes in short-term rates, there was only a marginal difference between the returns of cash and bond investments, while stocks outperformed significantly.”

Vanguard concluded by saying that there is a “high degree of uncertainty surrounding the future direction of economic growth, the deficit, inflation, and interest rates. Indeed, the difficulty of correctly forecasting not only which (if any) of these scenarios will unfold, but also precisely when, is a powerful reminder that focusing on interest rate moves and short-term changes in bond prices can be counterproductive.

“To us, the range of potential outcomes…would seem to support *greater* fixed income diversification in the years ahead, not less.”

Don’t take the bait!

If you use email, at some point you probably will receive a phishing message. Phishing is an illegal attempt to mislead consumers into providing personal or financial information via email, telephone or fraudulent websites in which thieves pretend to be a financial institution or other recognized company.

If you receive a phishing message claiming to be from an institution where you have an account, you might assume that a company's data systems have been breached. That's usually not true: phishers typically send their messages indiscriminately to a large number of recipients with the expectation that some will have accounts at the financial institution the phishers are mimicking.

The most frequent phishing attacks occur through email, although other media, including Twitter and pop-up messages, are also used. Phishers try to fool recipients into believing a message is genuine by mimicking financial institutions’ names, logos and email styles. That means a phishing message you receive may look like it could have come from someone at a company where you have an account. If that happens, some will recognize the phishing attempt for what it is and delete the message as spam. In the worst-case scenario, you could assume the message is a legitimate communication and respond to it.

To help you identify phishing scams, Charles Schwab & Co. Inc., the company where many of Mentor Capital’s clients hold their investments, offers the following tips:

Q: How do I recognize a phishing attempt?

A: Here are a few of their lines and lures:

- An email contains the word “urgent” and requests immediate action on an account-related matter. Phishers frequently succeed by getting consumers to act quickly without thinking.
- An email with an attachment is sent from a user falsely claiming to be a legitimate company. Unsolicited email attachments more than likely contain viruses. Do not open them.
- A pop-up window from a user falsely claiming to be a legitimate company's website asks for personal information.

Q: How did they get my email address?

A: Your address did not come from a legitimate company. Phishers collect email addresses from web pages and online bulletin boards and trade email lists with other spammers.

Q: What if I'm not sure if an email is from a legitimate company?

A: Use these criteria:

- Legitimate companies will never request or disclose a client’s personal information (account number, login password, Social Security number) in a non-secure or unsolicited email communication. They may send an email with a link to one of their Websites, which in turn may require a client to enter personal data (login, etc.) to be authenticated. If you have any doubts about a message's origins, contact us immediately. Never click on the link.
- If you get emails that warn you, with little or no notice, that your account will be closed unless you reconfirm your billing information, do not reply or click on any links. Instead, contact us immediately.
- When you enter account or personal information on the website of a legitimate company, it will always be protected by a secure Internet connection.
- You should never give out personal information such as your PIN, Social Security number, date of birth, etc., via email or over the phone.

Q: What if I fall for a phishing scam involving my Schwab account?

A: Schwab offers a security guarantee: Schwab will cover 100% of any losses in any of a client’s Schwab accounts due to unauthorized activity. Mentor Capital monitors activity in all client accounts and immediately reports any unauthorized transactions to Schwab. Clients who notice unauthorized activity may phone Mentor Capital or 888-3-SCHWAB.