



Corporate Bonds Versus Treasury Bonds

While corporate bonds have had slightly better returns than Treasuries, it is important to consider all the historical evidence before adding them to your portfolio.

While it is true that corporate bonds have outperformed Treasuries, we have not and do not recommend owning corporate bonds for two main reasons:

- They contain some of the same risks that stocks do.
- The historical outperformance has been very small.

One of the most important concepts of fixed income investing is that yield and return are not synonymous terms. The yield on bonds with credit risk (such as corporate bonds and high-yield bonds) overstates the return you can reasonably expect to earn. This is because some companies (for example, Lehman Brothers in 2008) will be downgraded or default and be unable to make all principal and interest payments.

In fact, there were more than 200 defaults in 2009 alone on Moody's rated corporate bonds. Historically, the default rate for investment-grade corporate bonds has been about 1 percent over five-year periods. The data shows that this risk has overwhelmed most of the initial yield advantage. For the period August 1988 through October 2010, consider the differences between the Barclays Capital Corporate Bond Index and a comparable portfolio of Treasury bonds.

	Annualized Return (%)	Volatility (%)
Barclays Capital Corporate Bond Index	7.9	5.5
Treasury Bonds	7.6	5.1

This shows that the returns on corporate bonds were very similar to the returns on Treasury bonds even though the difference in yields was on average about 1.3 percent. So almost the entire additional yield was lost due to downgrades and defaults over this period of time, which is why it is important to focus on expected returns, not yields.

The month-by-month results are interesting as well. For the 267 months over the time period referenced above, the corporate bond index only outperformed Treasuries in 60 percent of those months. Therefore, the performance differential is very inconsistent in addition to being very slight. And these analyses do not factor in the additional transactions costs and fund expenses associated with implementing a portfolio of corporate bonds.

In summary, the historical performance of corporate bonds relative to Treasury bonds has been both unimpressive and inconsistent. In light of the historical performance and the better diversification of fixed income securities with less credit risk, we remain comfortable with our general recommendation to forego corporate bonds in lieu of better alternatives.

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