What Happened to My Bonds?

As you are probably aware, the eight-week period from mid-June through mid-August provided a wake-up call for many investors as bond prices experienced a swift and significant decline. The largest bond mutual fund, PIMCO Total Return, managed by guru **Bill Gross**, was down 5% during that stretch. In the month of July alone, the Lehman Brothers Aggregate Bond Index (the equivalent of the S&P 500 for bonds) lost 3.4%, the worst monthly decline since 1981.

Why did this occur? According to famed Wharton professor **Jeremy Siegel**, "the bond market collapsed on the heels of a strong GDP and claims report." Gross Domestic Product is a primary indicator of the status of the US economy. Dr. Siegel has been suggesting that the thrust of the economy is clearly upward, and his assertion seems to be gaining support from many economic statistics. This pick-up in the economy has caused bond yields to move higher, and as you may know, yields and bond prices move in opposite directions. That is, rising interest rates have caused bond prices to fall. Why? Consider an example.

Suppose a $1,000 bond is issued with an interest rate of 3%. It will pay an investor $30 per year in interest. Suppose then that interest rates rise to 4%. An investor will now receive $40 per year on a newly issued $1,000 bond. As a result of the rise in interest rates, the 3% bond has become less attractive, and if sold, will now fetch a lower price in the marketplace.

These events have rattled many investors who either sought safety in bonds after suffering three consecutive years of stock losses or who were seeking higher yields than the measly rates offered by money markets. Some investors made the mistake of believing that their bond portfolios could never go down in value. Much of that thinking stems from a rear view mirror analysis of bond performance. Investors have benefited from a tremendous tailwind during nearly two decades of falling interest rates which produced record high bond prices. PIMCO Total Return has averaged nearly 9% per year since July 1989, when our firm first invested in the fund. In jumping on the bond bandwagon, what many investors failed to recognize is that, like the stock market, the bond market does not always go up.

What to Do? See the Big Picture

We should offer a bit of perspective here. In spite of the big sell-off in the bond markets this summer, PIMCO Total Return is still *up over 3%* year-to-date through the first twelve days of September. This brings up a couple of important points.

First, a big sell-off in bonds is not like a big sell-off in stocks. Remember, in its worst month since 1981, the Lehman Aggregate Bond Index was off 3.4% in July. Compare that to the S&P 500 stock index which was off 10.8% in September of last year. It is still true that inherently bonds have less risk than stocks (absent the risk of inflation) over most periods of time.

Second, remember that bonds are a diversifier for stocks and act as ballast in a balanced or conservative growth portfolio. Because stocks and bonds don't typically move in tandem, bonds generally offset some of the losses in the event of a significant decline in stock prices, as was the case from 2000 through 2002. On the flip side, the run-up in stock prices so far this year has far exceeded the overall return on bonds. These recent examples illustrate the merits of asset allocation.

In the long run, there is also an upside to the recent decline in bond prices. Those investors who are adding new money to their bond funds or reinvesting month-end distributions are getting more shares at a lower price (essentially, dollar cost averaging) with a higher yield than they did earlier this year.

What Not to Do? Speculate

For those investors who think they can time interest rate movements for purposes of moving in and out of the bond market, consider this observation picked up this summer at the Morningstar Conference in Chicago. Keynote speaker and legendary investor **Bill Miller** revealed that ***The Wall Street Journal's*** twice-a-year survey of leading economists had correctly forecast the direction of interest rates on only 13 of 41 occasions since 1982. How's that for performance? And these are America's best! Maybe they should have been paying attention to **Warren Buffett** in 1980 when he wrote in the Berkshire Hathaway annual report: "We believe that short-term forecasts of stock or bond prices are useless. The forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."

Whom We've Been to See

Since our last newsletter, members of our firm have made several noteworthy trips. Here's the rundown:

In May, Tim, Kevin and Julius traveled to Omaha to hear Warren Buffett and **Charlie Munger** talk about investing at the Berkshire Hathaway shareholder meeting. That marks the 17th consecutive meeting for Tim, the third for Kevin, and it was the inaugural trip for Julius.

While in Omaha, the group met with two representatives of the Weitz Funds. Unfortunately, with so many members of the value investing fraternity in town for the Berkshire meeting, **Wally Weitz** was able to join the meeting only briefly. Incidentally, two of his funds were just named to the ***Forbes*** Mutual Fund Honor Role, announced in the magazine's current issue.

The following week, Julius went to Memphis to attend the annual meeting of the Longleaf Partners Funds, and then he and Kevin went to Pasadena, CA to hear more from Charlie Munger at the Wesco Financial shareholder meeting. They also found time to go into Los Angeles to meet with **Michael Sandler** at the Clipper Fund.

In June, Kevin attended the Undiscovered Managers 5th Annual Wealth Management Symposium, where **Jeremy Grantham** delivered the keynote speech. Tim, Cecil, Kevin and Julius had previously met with Jeremy in Boston last August.

Later in June, Kevin returned to Chicago to attend the Morningstar Conference. Among those leading panel discussions were **Bill Nygren** of the Oakmark Funds, **John Rogers** of the Ariel Funds, **Chris Browne** of the Tweedy, Browne Funds and **Mason Hawkins** of the Longleaf Partners Funds. First Eagle Funds' **Jean-Marie Eveillard**, a longtime friend of our firm, was presented a Lifetime Achievement Award, and Kevin later attended a dinner party given in Jean-Marie's honor. Many long-time clients will remember Jean-Marie speaking at our client dinner at River Hills in 1998 (and some of you may recall his panning WorldCom stock!).

Who's Been to See Us

We also welcomed a noteworthy visitor to Jackson. In August, **Deborah McWhinney**, president of Schwab Institutional, traveled from San Francisco to our offices to meet with Tim, Sandi, Cecil, Marie, Kevin and Julius.

What We've Said

Kevin was interviewed for a ***Bloomberg News*** article about the Dodge & Cox Stock Fund. The article appeared in ***The Washington Post*** on July 13th.

On September 5th, Tim was interviewed by ***The Wall Street Journal*** for an article about mutual funds that put investors' interests first. He was also interviewed by ***The Clarion-Ledger*** for a September 9th article about saving money.

What We've Done

In May, Julius passed the Level III CFA exam and has now completed the requirements to earn the Chartered Financial Analyst designation. Congratulations, Julius!
In the July/August 2003 issue of ***Bloomberg Wealth Manager*** magazine, Medley & Brown was recognized as one of the top wealth managers in the country.

Pass It On

If you know of others who might benefit from reading our newsletter, please pass it on or e-mail us their name and address and we'll add them to our mailing list. We are now accepting new high net worth clients with $500,000 or more to invest.

Call us today for more information: Kevin Anthony, Cecil Brown, CPA / PFS, Tim Medley, CFP, or Julius M. Ridgway, Jr.
601-982-4123 • 1-800-844-4123 • Visit our web site at www.medleybrown.com

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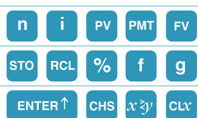
MEDLEY & BROWN
FINANCIAL ADVISORS
795 Woodlands Parkway, Suite 104, Ridgeland, MS 39157 • P.O. Box 16725, Jackson, MS 39236-6725
601/982-4123 • 1/800/844-4123 • Fax 601/366-0013 • mb@medleybrown.com • www.medleybrown.com



MEDLEY & BROWN
FINANCIAL ADVISORS

795 Woodlands Parkway, Suite 104
Ridgeland, MS 39157

P.O. Box 16725
Jackson, MS 39236-6725

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