DELTA INVESTMENT MANAGEMENT

Delta Insights
a weekly commentary on investing

Delta Investment Management is a registered investment advisory firm headquartered in San Francisco.
Delta welcomes discussions with individuals seeking investment advice and advisors seeking a new partner.
Delta manages portfolios at TD Ameritrade and Schwab.
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April 6, 2018

The Hidden Risks of "Safe" Assets

Money managers often advise clients who would like more safety in their portfolios to increase the weighting of bonds versus stocks. Historically, bonds have experienced lower volatility than stocks. Volatility (standard deviation) is one way risk is measured in finance.

Just as the S&P 500 Index is often used as the benchmark for performance by stock investors, the Bloomberg Barclays US Aggregate Bond Index (AGG) is a common benchmark for bond investors. The AGG is an investment grade corporate bond index.

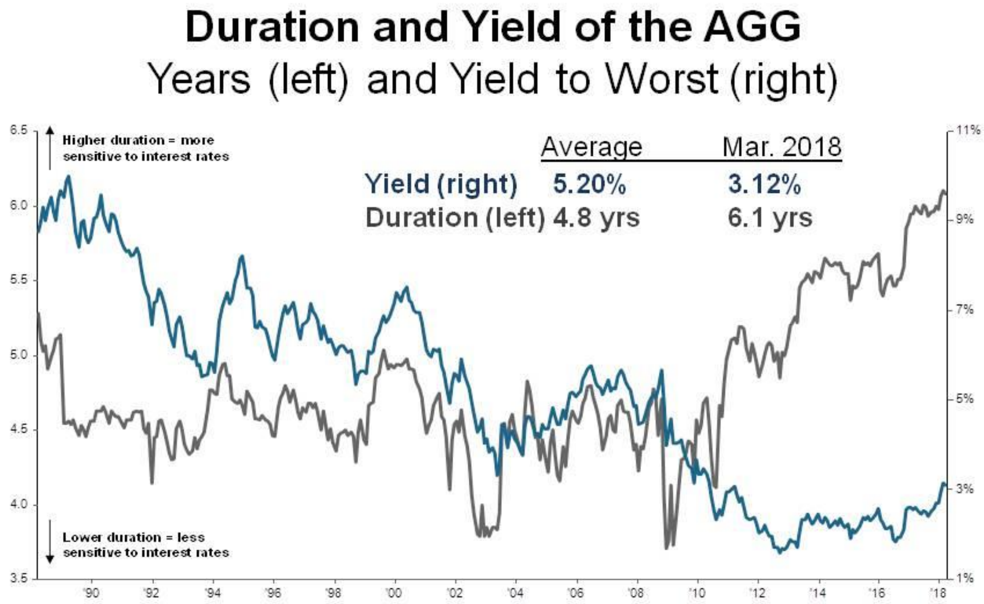
You might think that a benchmark would be a constant, somewhat like a unit of measurement. But unlike a gallon, mile or millimeter that is a constant standard of measurement over time, the S&P 500 and the AGG are always changing through time. The S&P 500 of 1980, for example, is nothing like the S&P 500 of 2018. Of the top five S&P 500 holdings in 1980 -- listed in order of largest to smallest: IBM, AT&T, Exxon, Standard Oil of Indiana and Schlumberger -- none are in the top five today. Today, the largest holdings of the S&P 500 are Apple, Microsoft, Google/Alphabet (A&C shares) Amazon, Berkshire Hathaway/Facebook (tied for 5th). Energy gave way to technology of the past 38 years.

Rising stars are added to the index and failing companies are expelled. Through time, the composition of the companies in the S&P 500 changes significantly. What is constant about the S&P 500 is it is comprised of many of the strongest and best performing companies in America.

The AGG also morphs through time, but unlike the S&P 500, not necessarily in a good way.

Bond investors face risk from two primary sources: 1) interest rate changes and 2) credit quality. Credit quality is the easiest to understand. Not being paid back is credit risk. Part of the interest an investor receives is to compensate them for credit risk. The other primary source of risk comes from changes in interest rates. When interest rates rise, bond values depreciate. The longer the duration of a bond (the amount of time before the borrower has to pay back the principal), the more a bond will decline for a given amount of interest rate change.

The chart below shows how the yield and duration of the AGG has changed since 1990.



Over the past 28 years and especially in the last eight years, the amount of interest paid by AGG is down substantially (-40% below the 28 year average) and the amount of interest rate sensitivity/risk is at all-time highs (duration is 27% higher than the 28 year average). In 1990, the yield was about 9% and the duration was roughly 4.5 years.

What investor would knowingly accept low yield and high interest rate risk at a time when the Federal Reserve has repeatedly stated they are raising rates this year and next? Year-to-date the AGG is down -1.67%. Over the past three years, it has returned about 1% per year. This is less than inflation.

By contrast, the S&P 500 has delivered average annual returns of 10.31% over the past three years, has an earnings yield of 6.2% and is trading at a forward 12-month P/E of 16.1x which is the 25-year average. Additionally, analysts are forecasting an excess of 20% increase in S&P 500 operating earnings in 2018.

There is no “sure thing”, “free lunch” or “safe bet.” There is elevated risk in bond investing today and the relative value of stocks to bonds is attractive.

Give Us a Call Today

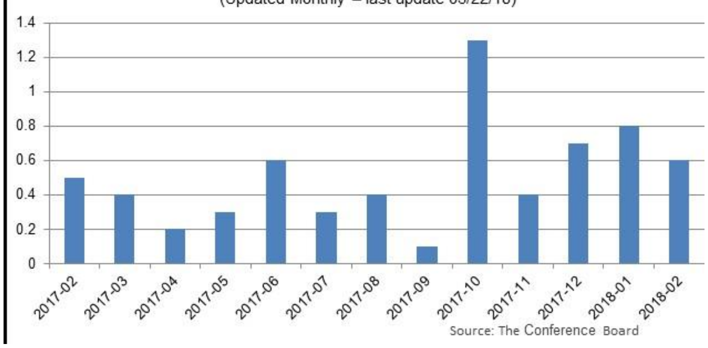
We invite you to give us a call at **(415) 249-6337**, visit www.deltaim.com or email us at info@deltaim.com if you have questions about how we can assist you in managing your investment accounts.

"Are you kidding me? I'm not watching golf. I'm watching Tiger."

Delta Stock Market Dashboard

Bear Market LEI
2006 - 2009

Leading Economic Index % Change Monthly
February 2017 – February 2018
(Updated Monthly – last update 03/22/18)



MARKET SENTIMENT IS

BEARISH

THIS WEEK'S NUMBER IS

31.7

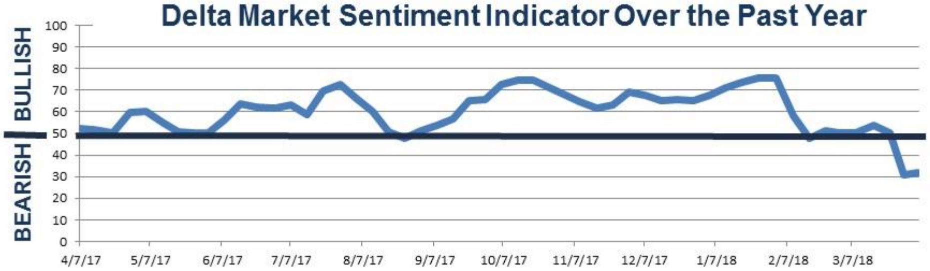
Our technical indicator increased this week from 30.7 to 31.7

INDICATOR STATISTICS

Consecutive Bearish Weeks:	2
Cycle Inception Date:	3/29/2018
Range:	30.7 – 31.7
Mean:	31.2
Bullish Weeks YTD:	12
Bearish Weeks YTD:	2
*S&P 500	0.2%
*DJIA	0.7%
*NASDAQ	-0.3%

** Percentage change during current cycle*

Delta Market Sentiment Indicator Over the Past Year



(Delta MSI is published every week in ***Barron's***)

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