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# The Independent Advisor

Quarterly Client Newsletter

## War Jitters and the Stock Market-- A Note from the Editor

portfolios and want to know what I think.

Several clients have called me recently. They are understandably nervous about what impact a possible war in Iraq might have on the stock market and their investment

As happened with the previous war with Iraq back in 1991, we are experiencing a period of constant rally-decline-rally as we approach a possible confrontation. A rumor of peace brings buying, the possibility of war, selling. The tendency for most of us is to want to be on the sidelines at this point and wait for the situation's resolution, one way or another.

I'll tell you why I don't believe the wait and see strategy is the answer. A lot of the fundamentals are good right now. Interest rates continue to be low and corporate earnings in some sectors are good. Even if the stock market seriously declines as we near the reality of the start of war, the chances are that it will go up once the war starts. Why do I say that? Back in 1991, as soon as the shooting started, the market went up and continued to do so. The decline in our market right now, then, is due primarily to the uncertainty of world events, not any fundamen-

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## Are Bond Funds the Answer in This Weak Stock Market?

Stock market losses have been piling up in the last few years, especially with a showdown with Iraq looming and the economy struggling to get back on track. Against this backdrop, sales of bond funds have been booming. In 2002, a record \$140 billion gushed into bond funds, while investors withdrew over \$27 billion from stock funds.

Bond funds are safer than stock funds, and they have given investors as much as 8% returns over the past several years, compared to steep losses in most stock mutual funds. So the answer seems clear, right? Why not head for bond funds, and investors will have nothing to fear.

Intuitively, this might make sense--except for one thing: rising interest rates. The biggest risk for bond investors right now is a phenomenon called interest rate risk. In the last four years, interest rates have fallen, spurred by numerous rate cuts from Alan Greenspan's Federal Reserve Board. That's the kind of environment in which bonds and bond funds thrive: as rates drop, prices of bonds rise, resulting in terrific capital gains for bonds, as well as steady income.

The party, however, may be over soon for bond funds. Even Bill Gross, the brilliant manager of the PIMCO Total Return bond fund, which is considered to be the premier bond fund in the country, said recently it's time to lower expectations for the performance of bonds. Most economists do not foresee the Fed lowering rates again; the next step, they agree, will be to raise rates, with that process beginning sometime in the next six to twelve months. When rates begin to rise, once again, bond funds suffer. That's not a problem if you hold individual bonds to maturity, but you will in fact lose principal with bond funds.

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Independent Financial Advisors 24 Waterbury Way, Pound Ridge, NY 10576 914-764-0367  
Christopher Kuehne, CFP

*War Jitters and the Stock Market Continued...*

tal weakness in our markets. It's the waiting that is hurting.

So, what am I doing right now in response to this tense situation? I am keeping a bit of cash on the side, looking for buying opportunities for good stock funds as they decline in anticipation of war. I buy them on the cheap, knowing they will probably go up once things settle down.

If history is any kind of a guide, the markets will rebound as soon as the shooting starts. The problem is, one never knows exactly when that will be. So, I believe the rational strategy is to buy on the way down now. Waiting until something happens may be too late.

Having said all this, let us hope somehow this conflict can be resolved peacefully and that the markets will rebound on the news that there will be no war at all.

### *Are Bond Funds the Answer Continued...*

What should investors do? As my clients know, I would never advise that they abandon their bond allocation for stocks. Each investor should have a comfortable, prudent investment mix of stock funds and bond funds, and they should not veer from that mix unless their goals or time horizons change.

My advice is to begin gravitating toward shorter-term bond funds, which have much lower interest rate risk. The last two times rates rose, 1994 and 1999, here's what happened to the returns of four categories of bond funds' returns:

	<u>1994</u>	<u>1999</u>
Long-term municipal bond funds	-6.20%	-4.78%
Long-term government bond funds	-6.12%	-6.04%
Intermediate-term bond funds	-3.77%	-1.24%
Short-term bond funds	-0.68%	+2.33%

As you see, short-term bond funds were hurt much less than long-term. Even having some of your bond fund exposure in exceptional intermediate-term bond funds would be acceptable, as long as most of your funds are short-term.

Bond funds have been the place to be in the past few years, with returns as high as 8% on average, but such funds will be hard pressed to match those gains in the next three years or so, and as you see, losses are a distinct possibility, especially for long-term funds.

As I've written before, the natural tendency for investors is to assume that what has recently happened in the market will continue. That's probably why everyone's jumping into bond funds - performance chasing. Rebalancing many portfolios today would probably entail shifting money from profitable bond funds into battered stock funds.

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### **About the Advisor...**

**Christopher** Kuehne is an independent, fee-only, Certified Financial Planner (CFP), Registered Investment Advisor and NAPFA-Registered Financial Advisor. He has worked in the financial services industry for 20 years in various capacities, including 12 years on Wall Street as a Vice President at Merrill Lynch and Bankers Trust Company. Mr. Kuehne has an M.S. in Economics from Carnegie-Mellon University, is a member of the Financial Planning Association (FPA) and the National Association of Personal Financial Advisors (NAPFA).