Market Insights – Choppy Waters

May 2025 Update

The past month and half have brought unprecedented volatility to both the stock and bond markets. Uncertainty surrounding United States trade policy, looming deficit issues, and domestic tax policy are not yet in the rear-view and will take considerable time to ultimately solve. Despite progress on trade negotiations, the leadership style of the current administration employs uncertainty as a tactical tool, which affects the short-term stability of markets. *We've used this short-term destabilization to add to high-quality growth equities that align with our long-term investment themes.*

Investors are understandably on edge, but there is nearly always a silver lining when markets misbehave. This edition of "Market Insights," will highlight some of the benefits of using individual bonds to compliment overall portfolio returns and smooth the ride. Even if far from retirement, all readers will likely have a need for some form of fixed income in their lives, so read on.

How the Bond Market Works (in a nutshell)

Just like individuals, corporations occasionally need access to borrowing. Instead of going directly to a bank, they issue very large sums of corporate bonds through an investment bank. The bonds are backed by the company's cash flows. Companies with stronger financials benefit from lower borrowing costs, much like a person with a high FICO score qualifies for lower loan rates.

After the bonds are created, they trade publicly in what is called the OTC market (Over-The-Counter), where brokers set bid/ask prices. If you've ever tried to buy a bond directly, you might understand how tricky it can be to determine its true value in the OTC market.

Brokers

The OTC market has no centralized exchange like stocks do (NYSE, CBOT, NASDAQ, etc.). Instead, broker-dealer's own inventories of securities that salesmen are encouraged to move. Think of this operating much like a car dealership. You tell the salesman what color and trim you like, and he finds the right one and collects a commission on the sale. Brokers sell to mutual funds, RIA's like Sandhill, and occasionally directly to individual investors.

Mutual Funds

Mutual's *have to* buy bonds when they see inflows to their funds, and have to sell when there are fund redemptions. This forced buying and selling can drive a mutual fund portfolio manager crazy, since he or she may not want to be a seller when their fund is receiving for liquidation orders. In these cases, the decision to buy or sell is not determined by market conditions, but by investor sentiment.

DIYers

There is a right and wrong way to work with a broker, and I can tell you after trading bonds for the last twenty years, most individuals would benefit from hiring a professional manager instead. Executing a bond trade without understanding the way the OTC market works can devastate an individual investor's quality of execution. *Brokers have no obligation to monitor your portfolio for credit changes and rarely have the knowledge or infrastructure to manage risks, such as duration and optionality appropriately*. A DIY approach to bond portfolio management should only be undertaken by someone well versed in the nuances and caveats of fixed income markets.

RIA's

As a registered investment advisor, Sandhill and our staff manage individual portfolios of bonds structured appropriately for your needs. Since we have no forced redemption or purchase mechanisms, we can sit patiently and buy only when the opportunity arises. Likewise, we are not forced to take losses and can ride out various interest rate environments with far more adaptability than a fund. We continuously monitor credit and will upgrade portfolios when necessary. The design of our bond strategy is designed to complement our equity portfolios. We use shorter maturities to minimize duration risk while gaining a better understanding of credit quality using fundamental analysis.

Why Bonds Now?

Back in early 2020, interest rates on the 10-year treasury bond fell to under 0.5%. Funds and individuals buying long duration bonds at those levels amassed irrecoverable losses after rates normalized over the following four years. Most of those investors were mutual fund buyers, or individuals who relied on a broker.

With corporate rates now moving toward the 4.5%-5.0% range, bond income is a perfect solution for those nearing retirement. For tax sensitive accounts, tax exempt muni's are also showing signs of value in specific areas of the curve. *Ultimately - a robust, thoughtfully managed bond portfolio allows for overall portfolio flexibility and can be used tactically to rebalance equity exposures during times of heightened volatility.*

US 10-Year Treasury Yield

*Source: Koyfin

Our recent bout of market unrest is a good reminder of how a properly structured portfolio, with the help of affective active management can produce good outcomes. Bonds are an important tool and are often the least understood part of a person's portfolio strategy.

If you think you might benefit from a deeper dive into this topic, or any others from past memo's, please don't hesitate to reach out. I'd love to hear from you!

Sincerely,

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