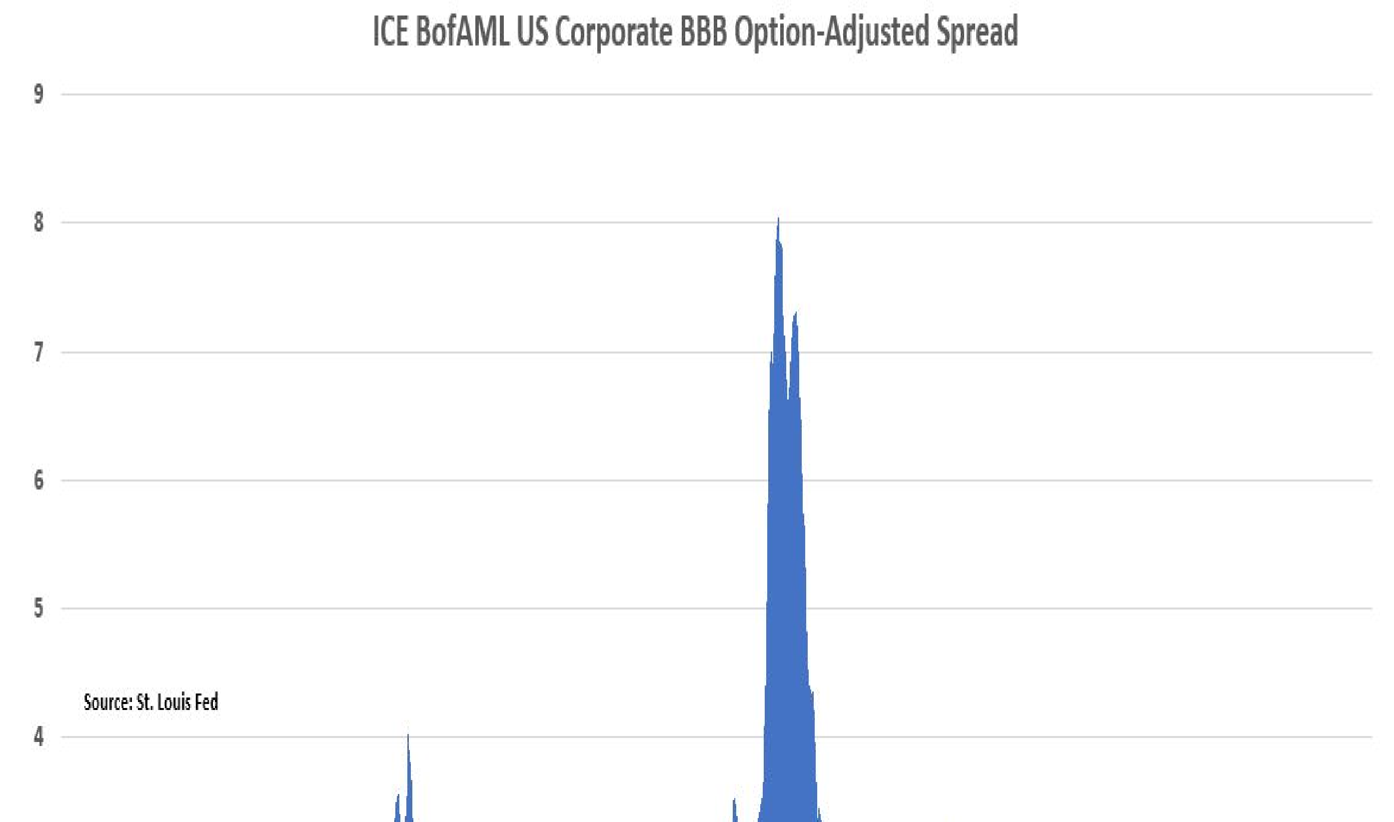
Last week, Jeffrey Gundlach of DoubleLine Funds noted in a webcast that investment grade corporate bonds are terrible. There is no way to win with them, he said. As much as half the investment grade universe could be downgraded to junk, and that will take buyers out of the market who can't buy junk bonds. On some basic ratios, Gundlach argued, a lot of investment grade debt should already be rated junk. Yesterday, DoubleLine Capital Portfolio Manager Monica Erickson was quoted in a Reuters piece arguing similarly that the investment grade corporate bond market is the worst place to be for bond investors. That part of the market has delivered negative returns this year. For example, the iShares Investment Grade Corporate Bond ETF (LQD) is down 5.50% for the year through November 15. The main investment grade bond index, the Bloomberg Barclay's US Aggregate Bond Index, is down 2.23% over the same period. This year, investment grade corporates have underperformed lower quality junk bonds.

Interestingly, it's not that investment grade companies are ready to default, noted Erickson. It's that the starting yield on investment grade corporates is so low that there is a lot of duration risk in them. That risk reflects how soon or long it takes for an investor to receive their money back in interest and principal payments. If interest rates increase, bonds with higher durations (fewer payments coming back to the investor sooner) suffer more because it takes an investor longer to receive their money back and invest in new prevailing higher rates. In addition to the higher-than-usual duration risk, investment grade corporates are yielding less over comparable Treasuries than they have previously. Echoing Gundlach's point, Erickson said BBB-rated (the lowest rung of investment grade) bonds had increased from 20% of the investment grade universe in 2008 to 50% of the universe today. In a downturn, bonds moving from BBB to BB may not find buyers easily since many institutions have prohibitions against owning junk bonds. The BBB-rated universe is around $3 trillion, while the entire junk bond universe is a little over $1 trillion.



The Reuters article said that Erickson favored bank loans over investment grade corporates, since bank loans have a floating rate feature. But they aren't foolproof either because of their extra dollop of credit risk. Investors should have a handle on their bond allocations. It may not be a bad time to overweight Treasuries.

Please click here if you have questions about how we manage bond portfolios.