

## MAKING THE CASE FOR BONDS

### *The Merits of Fixed Income in All Types of Market Environments*

As interest rates rose in 2013, driving down the values of bonds, investors showed understandable concerns about these bond market losses. When rates trend higher bond investors typically experience market value losses. Since 1928 years of bond losses have occurred regularly: the 10-year Treasury has had negative returns almost one out of every five calendar years. Still, investors have short memories and fears of loss have many investors questioning the merits of investing in bonds. This reaction aligns with the discoveries of behavioral finance which have demonstrated the power of human emotion to unbalance investment decisions.

Investors tend to place considerable more emphasis on the pain of losses than the pleasure of gains. Another factor may be myths and misperceptions about bonds. We encourage investors to ward off potential missteps by adhering to a well-thought out asset allocation plan we believe is appropriate for their specific situation. We've collected below reasons investors should consider allocating a portion of their portfolio to conservative, high-quality bonds regardless of market environment.

#### 1. To Potentially Provide Capital Preservation

Maintaining a long-term mix of assets ("strategic asset allocation") is a time-tested approach for achieving investment objectives. Consider the extremes: an investor moving between 100% stocks and 100% cash. To implement such a radical approach an investor would have to be proficient in market timing (e.g. getting into or out of riskier asset classes

at certain points in time). Experience and science support the notion that market timing as a strategy does not work well for most investors, increasing risk and often producing disappointing results.

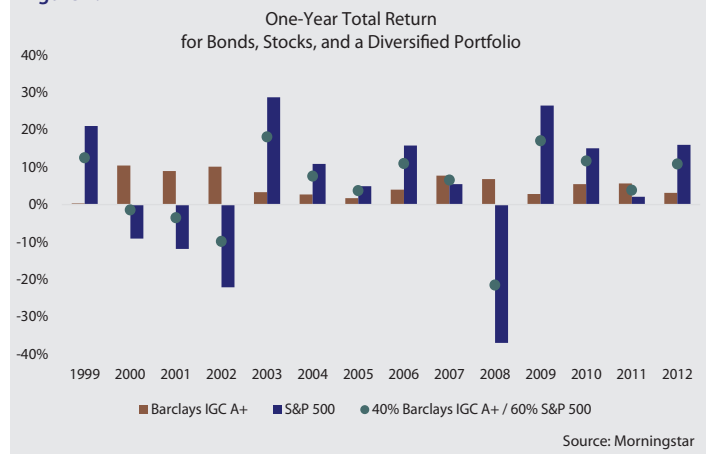
Figure 1 depicts the merits of a diversified portfolio. Since 1999 a hypothetical portfolio consisting of 40% Barclays Intermediate Government/Credit A or Higher index and 60% S&P 500 index outperformed a 100% allocation to the S&P 500 index in six out of the fourteen calendar year periods (43%) since 1999. This example illustrates how bonds may protect principal during certain market environments. Lastly, although small, short-term shifts in portfolio holdings ("tactical allocation") may provide incremental relative return, such an approach is subject to trading costs and the ability to time market movements.

#### 2. To Seek to Provide Income

Most fixed rate bonds make coupon payments twice per year and even in low yield environments, a bond's annual income is normally collected with a high degree of certainty. A predictable income stream can be an important factor even when bond holders wish the yield was higher. Why? Regardless of what happens with valuations of either fixed income or

equities, income from the bond portfolio should continue flowing to the investor — a positive in terms of partially offsetting market decline and possibly providing a bright spot during challenging market environments. Figure 2 (on next page) illustrates this point by showing the annualized total return and price return for multi-year periods going back to 1980. The price return is noticeably lower than the total return suggesting that coupon

Figure 1:



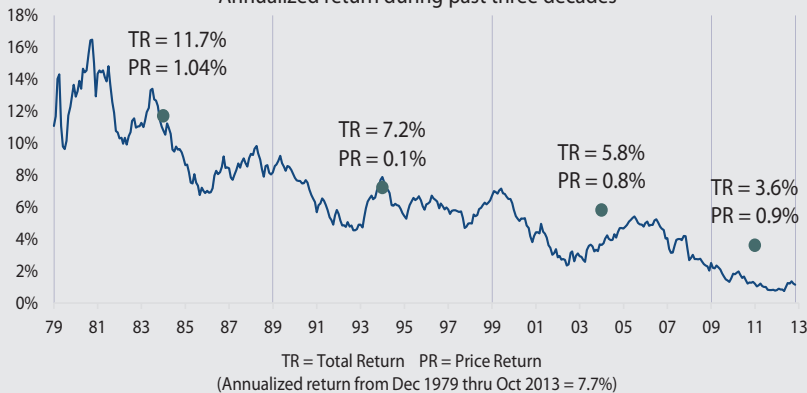
income was a key component of each period's total return.

#### 3. To Attempt to Reduce Portfolio Volatility

Markets can be shaken by unpredictable events. In fact, it is our observation that asset valuations are increasingly driven by attention-grabbing headlines. The desire for higher income and returns in our low-yield world has increased investors' appetite for risk. Since the 2008 financial crisis, accommodative monetary policy has

Figure 2:

Barclays Intermediate A or Higher Index  
Annualized return during past three decades



Source: Morningstar

caused riskier asset classes to appreciate, thereby fueling investor confidence. A look at past news events indicates what can happen when less than positive news surfaces – higher risk assets tend to lose value.

#### 4. To Potentially Provide a Source of Liquidity

Investors often allocate a portion of their portfolio to cash. This preference for

liquidity is intended to “keep some powder dry” for an eventual redeployment to purchase stocks or bonds at more favorable valuations. For all practical purposes, however, cash is considered more of a savings vehicle as opposed to an investment asset class — some important purposes of cash are near-term purchases and emergency funds. Investors with a desire or need for liquidity to protect

against the unexpected can be well served by an allocation to high-quality fixed income securities. High-quality, short-to-intermediate term bonds historically earned better-than-cash returns and can be liquidated very quickly with little or no impact on price.

#### Conclusion

It is our belief that almost every prudent asset allocation should consider some exposure to conservative fixed income, dependent on risk tolerance, goals, and objectives. While the current environment clouds this rationale, history shows many factors supporting this way of thinking. Presently, there is ample temptation to find additional income or return by allocating away from conservative fixed income towards riskier bonds or equities. Given the current low yield environment, bond market valuations, and ever-present uncertainty, we believe an allocation to conservative fixed income may be appropriate. ▀

*Mutual funds that invest in bonds are subject to certain risks including interest-rate risk, credit risk, and inflation risk. As interest rates rise, the prices of bonds fall. Long-term bonds are more exposed to interest-rate risk than short-term bonds.*

*Performance data quoted represents past performance. Past performance does not guarantee future results. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Visit [madisonfunds.com](http://madisonfunds.com) to obtain performance data current to the most recent month-end.*

*Consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus contains this and other information about the fund. Call 1-800-877-6089 to obtain a prospectus and read it carefully before investing.*

*Indices are unmanaged and do not include expenses. One cannot invest directly in an index.*

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