October 2010 – Fixed Income Investments

A year ago in our October 2009 newsletter we discussed fixed income investing. Although we made the point that in the long-term, stocks will outperform bonds, investors have voted with their money this year prioritizing preservation of capital over growth. The Investment Company Institute shows this by reporting that, through July of this year, investors have moved $1.7 billion out of stock mutual funds while making new investments of $162 billion and $23 billion in taxable and municipal bond funds, respectively.

Pundits have been saying that people are afraid because of the erosion of their home values and their equity securities in 2008 and are just seeking a return "of" their money as opposed to a return "on" their money. Consequently, we have seen rates continue to fall and fixed income investors well rewarded with higher bond prices and positive returns.

But what happens now? Rates on certificates of deposit and high quality securities are stunningly low. For example, Johnson & Johnson recently sold bonds maturing in ten years at a rate of 3.15%. By way of comparison dividends on its stock yield 3.5%. And Johnson and Johnson has increased the amount of this dividend each year for 48 straight years. IBM, McDonald's, Wal-Mart, and Microsoft have also issued debt at very low prices particularly compared to their dividend yields and history. Even BP, with all its well-known problems, sold $2 billion in 5-year notes which yielded only 3.19% on September 28, 2010. It seems that only the billionaires included in Forbes list of the 400 richest people could live on the income of their fixed income investments.

With rates so low some analysts are warning of a bond bubble. This should be of concern because the stock market bubble and the real estate bubble didn't turn out so well for owners of those assets. If there is any hint of inflation, rates would probably go up quickly.

Given these very low interest rates, we would again like to re-emphasize the risks associated with bonds. There are primarily four types of risks associated with bond investing:

Duration Risk

This is frequently characterized as interest rate risk. Duration is defined as the weighted average number of years to receive all cash flows (i.e., interest and principal) until the bond is paid in full. The longer the duration, the higher the risk of fluctuations in the value of the bond due to volatility in interest rates. If interest rates increase, the value of the current bonds will decrease as new bonds are issued with higher yields. Old bonds have to adjust in price to equalize the yield with the new higher yielding bonds. What this means to you is that if a bond has duration of 5 years, and interest rates were to rise 2%, the bond will decline in price by 10% (5 x 2%). Since a bond has a maturity its duration decreases as time passes and it will ultimately be redeemed at par. However, if it is sold before then, losses can be real and significant.

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Credit Risk
Credit risk is the risk of loss due to debtor's non-payment of a bond's principal or interest payments. Pricing can fluctuate with time due to economic conditions and other events. Government bonds are the least risky as the government has the ability to print money to pay the bond holders. Municipal bonds are also considered less risky as they are supported by state taxes and ad valorem taxes. Mortgages and mortgage-backed securities should also carry less risk as they come with collateral in the form of houses or commercial property. Such securities, however, suffered serious losses because of extremely poor, or even fraudulent, underwriting, ratings and securitizations. Corporate bonds generally have the highest level of risk as they are susceptible to changing economic conditions and event risk (e.g. BP).

Liquidity Risk
Liquidity risk quantifies the bid/ask spread in a security. The less liquid a security, the more compensation required to purchase that security. Government bonds are typically the most liquid with the narrowest bid/ask spreads. Liquidity also depends upon the sector and the frequency of selling new bonds by the issuer.

Inflation Risk
Finally, there is inflation risk, particularly with our large budget deficits and record amounts of government debt. When certain countries have experienced rapid inflation they have devalued their currency and paid their liabilities with a cheaper currency. The United States is subject to the same economic laws and, thus, is not different than any other country. Inflating our economy may be one of the solutions our government would employ. This would be devastating to bond holders, annuity owners, life insurance planning and non-inflation adjusted pensions. However, holders of bonds in another country which doesn't devalue its currency will benefit.

While no one can predict the future direction of interest rates, people should carefully review their situations to determine if bonds have a place. Chances are bonds will continue to be an integral part of your portfolio. But, with rates so low, great care should be taken before committing too much or for too long a term. Stocks of companies with good operations and strong cash balances, excess cash flow, and rising dividends should be favored. Prices will fluctuate and the volatility may make you uncomfortable, but you should attain your income goals until rates rise.

One final note, we have received feedback on our newsletters that our views are pessimistic. We are not pessimistic. You might say we are angry optimists. We are angry because of our politicians and the self-indulgent attitude of too many people. Our companies are not perfect, but their managements adapt, and they will find ways to be successful no matter what the environment. Their owners will be rewarded. In fact, with relatively low stock values, long-term investors should be well rewarded.

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