BEYOND TREASURIES & MUNICIPALITIES

Finding Yield without Sacrificing Quality

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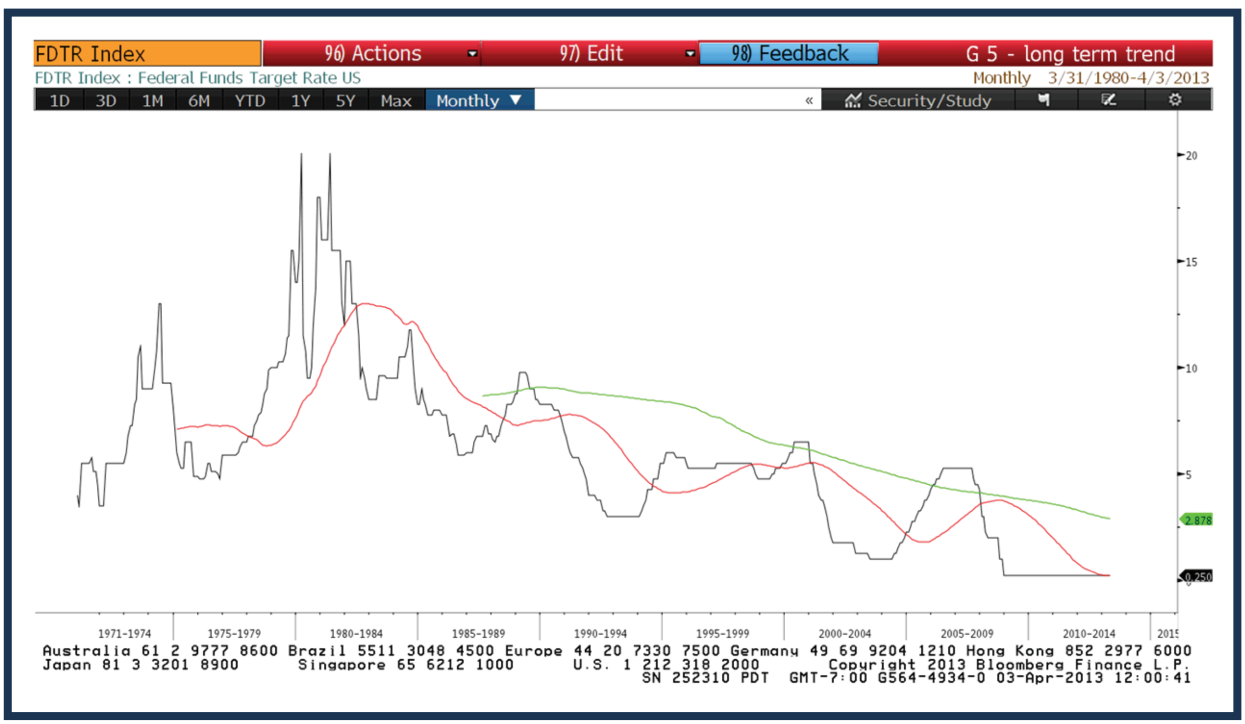
During the thirty years of falling interest rates (from 1982 to 2012), investing in high-quality income investments like Treasuries, municipal debt and investment-grade corporate bonds was a fairly straight forward investment decision. Investors could collect interest income, benefit from a gentle tailwind (falling rates propel bond prices higher), and have the comfort of knowing that these investments would hedge losses from equity investment during adverse economic times. *That 30 year trend is now over.*

On September 30th, 1981, the US 10 Year Treasury yield hit 15.84%. Paul Volcker had been appointed Chairman of the Federal Reserve in 1979 and promptly began waging war against the stagflation crisis of the 1970's. Stagflation is a term used to describe a situation where unemployment is high, economic growth slows but inflation remains high. Inflation had been steadily rising despite a slowdown in economic growth and by 1981, inflation reached 13.5%. In response, the Federal Reserve raised the Federal Funds target to 20%. Within two years, inflation had dropped to 3% and the Volcker Fed was credited with ending the crisis. People who took out mortgages in those years can still recall the details vividly thirty years later. Coincidentally, as inflation came under control, growth began to reassert itself and in 1982 the stock market began a long climb that would prove to be one of the strongest in history.

In the three decades since Federal Reserve Chairman Paul Volcker fought to break the back of inflation, interest rates have been falling. The long decline came in three distinct phases. The first decline began quickly. Once inflation dropped back to normal levels, the Fed lowered Fed Funds Rates. By 1986, the 10 year Treasury yield had fallen from 15% to 7%. Then, for twenty years interest rates moved sideways, falling gently from 7% to 5% between the years 1986 and 2007. Stocks benefitted from economic growth, easy credit conditions and falling interest rates. The rate of decline in interest rates quickened again during the global financial crisis and by 2009 the Federal Reserve that had raised rates to 20% in 1981 had dropped rates to 0%.



If the Federal Reserve's actions in 1981 were designed to stop price inflation in order to re-ignite growth, then the actions since 2008 signal a strong desire to re-inflate assets.

It is time to seriously consider the future implications of the Federal Reserve's zero interest rate policy (ZIRP). Interest rates are now being artificially held below normal levels. To be sure, the zero interest rate policy is designed to benefit banks, lending institutions, speculators and borrowers and has negative consequences for savers and long-term investors. The policy is designed to bolster economic growth through asset purchases, mergers, acquisitions and the expansion of balance sheets. In other words, it is the same playbook taken to a greater extreme. Easy credit and low interest rates tend to create asset bubbles and tend to be difficult to control once the money starts flowing into assets. Be that as it may, this is not a verbal attack against current policies. Instead, we focus on the opportunities and the risks associated with such policies, and specifically how we intend to fight back as investors and savers.

Opportunities

First, let's review several facts:

- Investment yields are near all-time lows
- Retirement income needs are growing
- The Federal Reserve has stated its willingness to let inflation rise
- Current economic policies are designed to propel asset prices higher (and thereby decrease the leverage ratios of balance sheets)

Within the income portion of portfolio allocations, there are a number of identifiable opportunities beyond traditional investment-grade choices.

Real Estate Investment Trusts (REITs):

The real estate recovery is underway and current interest rate policies directly benefit real estate in general.

Mortgages

Once toxic, many mortgages are improving, either from job creation or from improving real estate values.

Oil & Gas Pipelines

A steady source of income, pipelines transport energy across the country. A natural gas boom has begun and appears to be sustainable for the long run.

Improving Credit Corporates

Some corporations who have debt and have leveraged balance sheets are in growing and stable industries. In these cases, corporate debt profiles are improving and offer better risk/reward opportunities than junk bonds or AAA investment-grade bonds.

Foreign Country Bonds

While the US Treasury offers less than 2%, several strong countries with balanced budgets and growing Gross National Product still offer 4-6% yields on their bonds.

Dividend Paying Companies

Dozens of large US companies have raised dividend yields for 25+ years. Many of them can still increase yields even more. In the technology sector, some of the largest are just beginning their dividend payouts. Focus on companies with policies toward increasing dividends and with the cash flow to increase dividends every year in the future.

Equity Income Strategies

Covered Calls – by owning stocks and selling calls to other investors, this strategy can offer yields of 8% or more. This strategy is typically less volatile than owning stocks outright and can generate high income levels, even in tax-deferred accounts.

Time to Roll Up Our Sleeves and Dig Into the Details

Discipline relies on an attention to the details. Allocating assets must be disciplined and based on a confidence that comes from understanding the details of any investment. In contemplating a partial re-allocation from traditional investment-grade bonds, we must first be meticulous in our research. We must understand the risks and quantify them. Only then should we allocate assets. Thorough research can identify opportunities in any situation. Even during tough market conditions, opportunities can be uncovered.

Risk

Risk is not bad if it is understood and is quantified prior to a purchase. It is the unknown, the unexpected price movement that causes panic. Almost every investment opportunity will have more price risk than investment-grade bonds. Allocations being re-deployed from investment-grade bonds should be recognized as raising the price risk (volatility) of the portfolio. Research and proper portfolio construction will help to minimize price risks, but an increase in exposure to volatility remains.

Risks should be spread out across various types (interest rates, economic, inflation, etc.) and allocation weightings should be commensurate with an investor’s risk tolerance. Exposure to several difference strategies is essential to reducing risk from any single event.

A Barbell Approach

A fixed income strategy known as “barbelling” concentrates holdings into short-term and very long-term maturities. The idea is to increase yield in the long-term allocations and control risk through the short-term allocations. Taking this approach a bit further, we would seek to control risk by creating investment pairs that will reduce price risks but increase yields. If an investment-grade bond with only 2% remaining yield to maturity is replaced with a timely real estate income idea, the yield can move up from 2% to more than 8%. But price risk will increase exponentially as well. By re-allocating the investment-grade bond money into a pair of securities with different risk profiles, a new yield of 4-5% can be created while controlling risk and reducing exposure to any single negative event.

This approach will take more work and certainly more due diligence, but will improve the potential outcomes for the risk/ reward profile of the investment portfolio.

What to Avoid

Junk bonds are priced for economic perfection. Current junk bond prices suggest that fewer companies will declare bankruptcy than has occurred in past cycles. Perhaps this will prove to be true, but the current yield is not large enough to consider taking on that risk. In the financial crisis of 2008, junk bonds fell as much as equities. And yet, current potential profits from junk bonds are far below equities. If you have money to risk, equities offer a better risk/reward profile than junk bonds.

Many marginal corporations survived the crisis by re-financing debt and laying off workers. Those are one-time savings and for many of these marginal players, a minor downturn could become catastrophic. Some companies chose to reduce leverage and debt in the years following the financial crisis, and those companies have improved their potential to survive. But far too many companies remain on shaky foundations, living on borrowed time.

Investment-grade bonds with yields below two percent are at risk of producing returns below the rate of inflation. With the exception of liquid, safety-seeking assets, a long-term allocation to any investment that cannot beat inflation will result in a loss of purchasing power.

Think outside the box when it comes to income. There are numerous opportunities that can increase yield without substantially increasing risk.

Conclusion

All of these facts, when put together, reward growth and reward risk-taking. Profiting from current trends and opportunities are important. And at the same time, risks are increasing. Reach for yield in areas that are supported by low interest rates, improving trends and cash flows. Invest in areas that are overlooked and cheap relative to history. But avoid areas that are over-priced and beware of asset classes that are pricing in perfection (like junk bonds). This economic recovery is leaving much of the American middle class behind and remains tepid.

Some investments have sustainable and powerful earnings trends. Others are cyclical and can be very good when the timing is right. Always be sure to differentiate the prior from the latter.

As income allocations are adjusted to meet current yield needs, be sure to adjust risk in the growth allocations or to sufficiently spread out risks. A portfolio is not improved by increasing the yield of a portfolio by 2% while increasing risk of loss by 10%. A diverse mix of strategies and allocations to several investment themes can significantly improve a portfolio, both in terms of yield and risk.

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