StoneRidge Wealth Management

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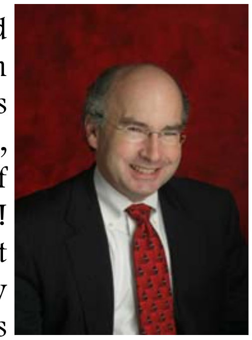
The Quarterly Profit

Riding The Yield Curve

(And Other Jolly Bond Topics)

Let's talk about bonds. Many clients have expressed their discomfort with bonds, saying that they really don't understand what bonds are, or how they work. It's time for a quick review. First, let's distinguish between stocks and bonds. We all know that when we own a share of stock, we actually own a little piece of a company. We can make a killing on Ba-Boom To The Moon, Inc., lose our shirts on Gotcha Corp., or go absolutely nowhere with The Flat Line Company. Unlike a stock, a bond doesn't represent an ownership interest in the company itself. Instead, a bond is simply the company's marker that it owes someone some money. That's all there is to it! A bond is nothing more than a written I.O.U. to pay back the money just borrowed, with a promise to pay a stated rate of interest per year until the date that the loan (the bond) matures, or comes due. Bonds can be issued by corporations, municipalities (cities, counties and states) and countries. The greater the borrower's financial strength, the lower the interest rate on the bond. Conversely, a lower credit rating will have to pay more interest per year, because the lenders require a better return for the additional risk they incur for making the loan. Any takers on Greek bonds? This is all pretty much straight forward, but what happens when we try to buy or sell a bond after it is issued, and before the maturity date? This is where things get a little more complicated.

Let's pretend that G.E. issues a bond that pays 5% per year. (Compliance requires me to state that I'm not promoting the company or the bond, and that past performance is not a guarantee of future return. I think we all get that.) Joe investor buys $10,000 of the G.E. bonds through a broker, and is delighted that he will earn $500 per year interest. (5% x $10,000) A couple of years pass, and let's assume that inflation has kicked in. The cost of money has gone up, and now Johnson and Johnson (please, no plug for the company) issues a bond for 6%. Joe has been happy with the 5% he's been receiving from G.E., but now he wants some of that hot 6% J&J action! Trouble is, Joe doesn't have any extra money lying around, so he tries to hustle his neighbor, Sue, into buying his wonderful 5% G.E. bond for the $10,000 price that he paid. Sue didn't just ride into town on the turnip truck, and she says "Forget it" because she's going to buy $10,000 of that new J&J bond that pays 6%! As Joe starts to slink back into his house, Sue says "But Wait! I'll buy your G.E. bond, Joe, but I'll only give you $8,000 for it." Do you see what's happened? Joe's bond is selling at a Discount (reduced price) because the interest rate environment has changed. When interest rates are rising and new bonds are paying more interest than older ones, the market values of existing bonds begin to drop. Even though Joe and Sue expect G.E. to continue paying 5% on the bond and also the original $10,000 when promised, the market value of Joe's bond today simply isn't worth the $10,000 he paid a couple of years ago. After Joe sells the bond to Sue, G.E. will now send the $500 interest to Sue because she is the registered owner. G.E. doesn't know or care what Sue paid Joe for the bond; G.E.'s promise is to send $500 to whoever owns the bond. But because Sue only paid $8,000 for Joe's bond, the $500 per year YIELDS Sue about 6.25%.



Now, what if interest rates had fallen in those two years, and J&J had issued a bond for 4% instead of 6%? You got it! Joe's 5% bonds start looking pretty good, because he's pulling in $500 interest compared to the $400 that Sue will receive if she buys $10,000 of the new J&J bonds at 4%. (4% x$10,000) Now the tables are turned, and Sue wants some of Joe's 5% G.E. action!

Riding the Yield Curve (continued)

Joe is no dummy, and he won't sell his G.E. bonds to Sue unless she gives him a hefty PREMIUM for them. Joe sells his bonds to Sue for $12,000, and G.E. starts sending the $500 to Sue, because she is the new registered owner. But because her $500 is on a $12,000 investment, her YIELD is only about 4.2%. This is called "Riding the Yield Curve", and is the most important concept for the bond investor. Depending on changing interest rates and market conditions, the actual yield (the percentage return) on the bond investment will rise and fall.

We've been hearing lately that bond yields are at an all-time low. This is because the interest rate environment (the cost of money) is exceptionally low, but also because investors are so concerned about the stock market's volatility that they are "fleeing to quality" by buying more bonds, and paying a premium for them. Even though most bonds (other than US Treasuries) are not guaranteed and bonds can lose money, their market values have been generally rising because of the increased demand, and their yields have been dropping for the same reason.

The $100 Million question, then, is the optimal percentage of stocks to bonds in a retirement portfolio, given the relentless market volatility of the last few years and tomorrow's uncertain global economy. Since last fall, I've been recommending that we increase our percentage of bonds and other fixed income products. Earlier this year it seemed that the bonds were beginning to drag on a steadily improving stock market, until the elections in France precipitated another market retreat for the entire month of May. Now, we may be clawing our way back to where the markets were at the end of April, but we must be aware of a slowing global economy, the continuing financial crisis in Europe, and the growing recognition that our own deficit is at a very dangerous level. We must always think of the stock/bond ratio as a teeter-totter, and be willing to add to bonds to help balance stock market risk. Depending on the individual client's short and long term income needs, plus one's general tolerance for risk, we should probably consider between 35% to 50% of bonds and fixed income investments as a new benchmark. My personal opinion is that the markets will be volatile for another year at least, until a new global growth cycle begins. Let's look for protection first and growth second, and consider bonds for their income and relative stability. But don't forget the ride on the yield curve!

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Rock Solid Retirement & Estate Planning

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