WHAT IS ALL THE FED'S TALK OF TWISTS AND TAPERING?

The Federal Reserve Bank has not only held short term interest rates close to zero for four years, but has also used other tricks to keep money flowing in order to help the economy. One of the tools, Operation Twist, is a bond swap procedure named after Chubby Checker's song. Realizing that one day they will have to increase rates and stop all the other stimulus procedures, the Fed is trying to give investors a heads up on when it might happen in order to prevent a bond market bloodbath that brings down stocks and the economy. Rather than saying they are going to REDUCE the additional stimulus, they have chosen to say they will TAPER it, as that word is less harsh.

WHY IS IT SUCH A BIG DEAL?

When interest rates increase, bond prices drop. The lower the starting point from which rates begin to increase, the worse the price decline. The longer rates have stayed low, the worse the decline in bond funds. Since rates have never been this low for this long, unwinding the stimulus is likely to cause unusually large declines in bonds. Participants in the economy are now accustomed to rock-bottom rates and adjusting to the higher cost of financing things like houses, cars, tuition, and business expansions, will likely cause disruptions in budgets.

BEN "TOP GUN" BERNANKE'S FREUDIAN SLIP

While trying to ease investors' concerns in a recent speech, Fed Chairman Bernanke blurted out a surprising metaphor describing the Fed's goal of unwinding the stimulus. He stated the Fed would be "shifting the mix of our tools as we try to land this ship on a, you know, on a – in a smooth way onto the aircraft carrier. The – sorry." Minutes later, a CNN journalist pointed out the obvious worrisome nature of comparing a smooth landing to one which requires hooking a wire on a moving target, opening the throttle in case you have to have an emergency takeoff, and if successful, being yanked to a halt in a couple of seconds.

WHAT SHOULD BE DONE WITH A PORTFOLIO'S BOND ALLOCATION?

Investors' bond allocations need to be examined to attempt to prevent potential declines from rising rates. As usual, Wall Street has rolled out products touted as providing the solution. Many of these "solutions" are essentially just high dividend stock funds, floating rate bond funds, and bond funds that can "go anywhere". Beware of these pitches, as they are either flawed, or don't address why investors own bonds in the first place. The problem with the first should be obvious. Stock dividends aren't a good substitute for bond interest. Bonds are held for safety, not income. Otherwise, it would make more sense to be entirely in stocks and just sell some whenever one needed cash to spend. Floating rate funds typically do hold up in price in a rising rate environment, all things being equal, because rates on the bonds adjust to overall rate changes. This helps keep them from getting left behind when rates are increasing. The problem is that they are from higher-risk companies and the prices can substantially decline during recessions and stock market declines. Therefore, while the interest rate risk is reduced, it comes with downside volatility that is closer to that of stocks. This works to defeat the purpose of diversifying into bonds. The go-anywhere or "unconstrained" bond funds have the pitch that the managers have more investing leeway and will be able to shift into bonds that won't decline when rates increase. This is theoretically possible. However, when times are bad for an investment category, different subcategories become highly correlated. It's likely that other bond categories, such as international and emerging markets, will exhibit declines that are in near lockstep with U.S. bonds -- even if those countries aren't officially increasing their rates. (And this is exactly what happened during the recent sell-off.)

ALTERNATIVES TO BONDS

We have developed a list of six categories that could potentially replace the cushion function that bonds have historically played in portfolios. Three are simply subsets within the bond universe, and three are more specialized non-bond categories. Fully describing these categories is too large of a topic for this report, but the categories are: Low Duration High Yield, Low Duration Investment Grade Corporate, Higher Quality Floating Rate, Merger Arbitrage, Market Neutral, and Currency Funds. Each of these categories normally exhibit volatility and return potential that is similar to what various bond categories normally experience. However, their price fluctuations are less correlated to rising interest rates than most bonds.

ACTION PLAN

We will be making portfolio adjustments to replace certain bond funds that have more risk for potential loss with funds in the categories described above. The hoped for outcome is for portfolio allocations that retain similar risk and return characteristics, yet have much less exposure to the potentially large losses that bonds could experience. A more detailed, six page report on this topic is available on our website.

LIMITED 401(K) CHOICES PROBLEM, IN-SERVICE ROLLOVER OPPORTUNITY

Company retirement plans such as 401(k)s typically have a very limited selection of funds. This presents a large problem for pre-retirees that could end up incurring large declines on a substantial portion of their retirement nest egg. Most plans allow participants over age 59 ½ to roll over their account into an IRA even while still employed. This then gives them the opportunity to gain access to the bond-alternative categories listed above. If you or any of your friends, family, or current or former coworkers could benefit from this type of rollover, feel free to pass along this report or request additional copies. A copy of this and the more in-depth report are also available on our website, www.ryanpoage.com, in the "Client Newsletter" section.

In any regard, here's to hoping the Fed catches a wire with its tailhook and avoids either having the economy careen off the flight deck or being forced to keep open the throttle of stimulus to create another takeoff.