PAINTED INTO A CORNER

The Federal Reserve Bank's lowering of interest rates has helped the economy pull out of the Great Recession, which has resulted in the stock market recovering from a decline which led it to reach its 1996 levels … in 2009. The issue now, is how the Fed unwinds its low interest rate policy without causing enormous problems as investors react to the moves that will take us away from the uncharted territory that the world has grown accustomed to for five years.

This report will attempt to shed some light on what is happening with interest rates and bonds, and how it affects you as an investor and participant in the economy.

BEN "TOP GUN" BERNANKE'S FREUDIAN SLIP

As I was beginning to lose attention while watching Fed Chairman Bernanke give his market-jarring speech in June that gave more direction on when the Fed would start to unwind its stimulus, my ears quickly perked up when he blurted out a surprising metaphor in describing the Fed's goal of trying to unwind the stimulus. In answering a journalist's question 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." His body language and delivery of the final thought matched the awkwardness of the comparison. A few minutes later, a journalist from CNN pointed out the obvious, that the comparison was worrisome because in his personal experience, landing on an aircraft carrier was always a bit jarring. The bond market's enormous influence and interconnectedness with all aspects of society has a history of eliciting colorful comments from those in power, and Bernanke's comment reminded me of a famous statement in the early '90s from Bill Clinton: "You mean to tell me that the success of the economic program and my reelection hinges on the Federal Reserve and a bunch of (expletive) bond traders?"

The fallout from this change in interest rates not only matters to individuals and entities that will be facing higher interest payments on loans, but also to any investors owning bonds or bond funds. Furthermore, the ripple effect of these changes could shortly, if not simultaneously, spill over into all other investment categories and the broad economy. The most direct effect that could cause problems for investors is that when interest rates increase, the prices of existing bonds decrease. This is a tried-and-true relationship, and any investor that has had exposure to bonds for many years has experienced the ebb and flow of rate movements and prices. However, this time it's (probably) different. The reason is that the lower the starting point from which interest rates begin to increase, the larger the magnitude of the price declines.

A lesser-understood variable that affects the magnitude of price declines that an investor experiences stems from enduring a multi-year period of low rates in a bond portfolio such as a bond-focused mutual fund. When a portfolio has older bonds that are paying higher interest rates, it acts as a cushion to the effects of low rates. This helps reduce the ensuing price declines when rates increase. When rates were lowered to extremely low levels in the early 2000's to help the recovery from that recession, short-term rates bottomed at 1% and remained at that level for one year. The more recent recession's stimulus brought them down to 0-0.25%, and has kept them there for four and a half years. Thus, many more bonds have been refinanced at lower rates, leaving bond funds with less cushion from older, higher-interest bonds. As such, the price declines from here will likely be more pronounced than those experienced the last time the Fed unwound its stimulus.

The difficulty with unwinding the Fed's low-rate policies is that even though the stimulus might be unwound in a slow, tempered manner, the participants in the bond market are likely to act preemptively in a rush out the door so as to not be left holding the bag. This is exactly what happened in May and June as the bond market plunged at the mere hint of the Fed discussing a policy change. This was likely just a small preview of the disruption to come.

WALL STREET "SOLUTIONS"

In typical form, Wall Street has been rolling out products that are touted as being a solution or alternative to bond price declines that occur from increasing rates. Beware of these pitches, however, because they are either flawed, or don't address the reason why investors own bonds in the first place. The newly touted alternatives to bonds include high dividend stock funds, floating rate bond funds, and "unconstrained" bond funds.

The problem with the stock dividend alternative should be obvious. Stock dividends are not a good substitute for bond interest. Why? Because if one really peels back the layers of why investors buy bonds, it isn't for the income payments. It's for the safety compared to other choices. Otherwise, it would make more sense to be entirely in stocks and just cash some in when one needed money to spend. That doesn't work too well during a bear market though, so bonds play an important balancing act. Therefore, trying to avoid potential losses in bonds by taking on the risk of stocks isn't an ideal plan. Likewise, going into other dividend or yield-oriented categories poses the same risk. Any investment in which an expected, recurring cash payment represents a significant portion of the potential return is going to be sensitive to changes in interest rates, just like bonds. Therefore, investments like high-dividend utility stocks, preferred stocks, commercial real estate, rented farmland, and yield-oriented energy partnerships typically always see their yields for new buyers increase if interest rates are increasing. How are the issuers of all these investments able to simultaneously increase their payouts when interest rates rise? Well, as you might have guessed, the increase in yield for new buyers is solely a function of the price declining. For owners of investments that don't have a maturity date, such as the previously listed categories, the interest rate sensitivity is even more pronounced than it is for bonds. For instance, renting out farmland has been a recently hyped craze. However, if the required yield for new buyers crept up to 5% from the 4% that is common today, that would translate into a 20% drop in the price of the land. Yeah, they're not making any more of it (land), but that doesn't mean that it can't turn into a lousy investment.

Loading the boat with floating rate bonds isn't a great idea either. Since the rate on these bonds resets periodically (often quarterly), in a rising rate environment, the rate will ratchet up, which should minimize the normal rate-induced price declines. The problem with this is that these bonds are issued from riskier companies, and typically decline in price during recessions and stock market declines, since the risk of not getting repaid increases. Thus, if investing in this category, it is important to focus on the higher quality components. Lastly, 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.)

WHAT IS AN INVESTOR TO DO?

After analyzing this potential market problem, witnessing the preview the market has given us in the form of a nasty selloff that caught the Fed off guard, and surveying the landscape of potential investment categories, we have come up with 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.

LOW DURATION HIGH YIELD

These are high yield bonds from riskier companies. The feature that seems to make them appealing in a rising rate environment is that the interest rates are higher than government bonds and the average maturity is kept very short in low duration funds. These two characteristics help minimize the impact from increasing rates. While price declines would occur during a recession or stock market decline, this should also be minimized since bonds will constantly be maturing.

LOW DURATION INVESTMENT GRADE CORPORATES

The description and characteristics of this type of bond are the same as those described above, except that the companies have better credit ratings and lower risk. With the lower risk, comes lower expected return.

HIGHER QUALITY FLOATING RATE

While these have just been described as having considerable downside exposure when the economy and stock market are declining, it is important to note that there are different levels of risk within the category. In focusing on the category for its ability to provide a cushion compared to the stock market, it is important to focus on higher quality bonds that should hold up better during economic and market stress. As such, the expected returns will be lower. Funds that invest in higher quality floating rate bonds are likely to have generated lower returns for the past several years when compared to their more aggressive peers. For this reason, the funds that probably make the most sense owning now are the ones with recent performance that seems lackluster.

MERGER ARBITRAGE

This is a category of investing that attempts to take advantage of the stock price movements that occur after a corporate acquisition is announced. When a company acquisition is announced, it is usually for a premium to the existing stock price. Typically the premium is approximately 30%. When the announcement is made public, the stock price of the company getting bought usually starts immediately trading at a price close to the buyout price. However, typically it trades at a discount ranging from 2-5% of the price. This reflects the market factoring in the risk that the deal might fall through and not close. Closings are usually completed 3-9 months after the announcement. For example, if an investor buys the stock at a discount of 3% from the buyout price, and it takes six months for the shares to be redeemed for cash at closing, the return works out to a little over 6% if annualized over the course of a year. Since stocks in companies getting bought for cash have a known exit price, the share prices typically are not swayed much by the normal gyrations of the market.

Like all investing, this method isn't without risk. The big risk here is that a deal falls through. If this happens, the stock will typically fall to a level close to where it was trading before the announcement. Therefore, it is important for a fund manager in this category to focus on buying companies in which the likelihood of the deal getting completed is good. This type of investing can also be done with companies when the purchase is being made with the acquiring company's stock, or a combination of stock and cash. When this is the case, extra transactions in the acquirer's stock are made in an attempt to offset the risk of that stock declining.

Overall, this is an old strategy, but it doesn't get looked at much by individuals because it doesn't fit into a clear-cut category. It's in stocks, but because of the typically lower-risk way of investing, the long-term returns dramatically lag those from normal stock investing. The volatility figures are also typically much lower and look more like those from bonds, but that detail usually gets overlooked when focusing on the "poor" performance compared to regular stock funds.

MARKET NEUTRAL

This method of investing also primarily is focused on stocks, except that instead of just buying stocks that appear to have the potential for price appreciation, roughly equal dollar amounts are invested in a manner that will make money if stocks that look likely to fall do indeed decline. The net intended result of this is for much of the portfolio's volatility to be diminished compared to the overall market. This is possible because when the overall market is declining, roughly half of the portfolio could be experiencing gains. This works the other way too, in that when the market is increasing, roughly half of the portfolio could be experiencing losses. The goal is to have the fundamentally strong companies earn a little bit more return than the overall market, while having the fundamentally weak companies either decline or at least appreciate less than the market. If this is what happens, an investor can be left with these incremental amounts of return, while having the portfolio volatility look similar to that of a bond portfolio.

The risks here are that losses could result from both groups of companies, the ones that an investor hoped to have increase and those he hoped would decrease. To help minimize this, fund managers usually include several hundred stocks in a portfolio to create a broad mix on both sides that will more closely resemble the broad market's gyrations. Like merger arbitrage, this is an old strategy that often gets overlooked because the long-term returns usually pale in comparison to traditional stock funds. Likewise, the volatility is usually far less too, but low volatility and low returns in a stock fund package don't make for a great advertisement.

CURRENCY FUNDS

Lastly, and somewhat hesitantly, currency funds are a category that could provide the potential for muted returns with downside risk that isn't entirely correlated with bonds, and an overall risk level that is typically somewhere in between stocks and bonds. There is hesitation in mentioning this category, only because it sounds more exotic, and therefore riskier than more traditional categories. In reality, the perceived riskiness usually stems from the possibility to trade currencies with very, very little money down in the foreign exchange market. For example, if something has yearly fluctuations that normally fall within a range of 5-10%, that typically wouldn't be considered overly risky. (For reference, the typical fluctuation ranges for stocks and investment grade bonds are around 15% and 5%, respectively.) However, if for example, you wanted to take a $10,000 position in something, but were told that you only had to initially put up 2%, or $200, then you would have a structure where you would make 100% on your deposit if the investment increased 2%, and would lose 100% if it declined 2%. This is how a lot of people get involved in currencies. The greed causes them to turn their originally desired position of $10,000 into a leveraged one that represents $500,000 in total size. You know how this story ends.

That being said, if an investor doesn't fool around with investing with borrowed money they won't be artificially increasing the risk level of the actual investment. With currency funds, investments are typically made in currencies of countries where the central bank is increasing interest rates versus countries where rates are lower and/or declining. If a country is increasing interest rates, it typically means that the economy is strong. The increases in rates are a means by which the government is attempting to keep a lid on inflation. In these scenarios, investment dollars from around the world tend to find their way into the country to participate in the strong economy and also to sit in cash and earn higher short-term savings rates than what the investors could get in their home country. This extra demand for the currency of the strong economy tends to drive the currency higher in comparison to other, weaker countries.

The risks here are essentially just like any others in investing, that the investor is incorrect, and the price of what they buy declines. However, there is an extra moving part. When funds invest in currencies that don't involve the investor's home currency at all (for instance if a U.S. investor is in a fund that establishes a position in the Euro versus the Yen as opposed to the Euro versus the U.S. Dollar), then there is the additional risk that the original investment is profitable, but turns into a loss when converted back into their home currency or that a loss becomes greater upon conversion. (This works the other way too, as the conversion can potentially increase the return.) Currency conversion risk is actually also present in any traditional international stock and bond fund.

In addition to the unexciting combination of so-so expected returns for so-so expected risk, currency funds are also typically ignored by individual U.S. investors because of the unfamiliarity with the mechanics of currency conversions and the horror stories of people that thought it sounded fun doing it directly with 49 borrowed dollars for each dollar of their own.

ACTION PLAN

While the reality of unprecedented declines after a historic 30 year bull market in bonds might not occur, especially if unforeseen events were to push the economy into a recession, the risk that exists in the unwinding of today's near-zero interest rates is large enough to warrant looking elsewhere for a diversification cushion for stocks. Additionally, the opportunity cost of foregoing interest from bonds is practically nonexistent due to miniscule rates. As such, 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 portfolio allocations that retain similar risk and return characteristics, yet have much less exposure to the potentially large losses that bonds could experience.

LIMITED 401(K) CHOICES CREATES PROBLEM

An area that poses problems for investors arises from the limited choices offered in most 401(k) and workplace retirement plans. These plans usually offer a small menu of fund choices that cover the primary categories like small, medium, and large U.S. stocks, and two or three bond funds. It is extremely rare for plans to offer more unique categories like the ones described above. This presents the situation where many pre-retirees, that have an appropriate weighting in bonds to the tune of 30-40% of their portfolio, are facing the prospect of seeing significant losses on a large portion of their retirement nest egg.

IN-SERVICE ROLLOVER OPPORTUNITY

An important way to gain access to more fund choices with 401(k) money exists with most 401(k)s through what is called an In-Service Rollover. Typically, employees that are 59 ½ or older are allowed to roll their accounts into an IRA even while still employed at the company. Rolling out of a limited-option 401(k) allows access to the bond-alternative categories previously described. 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 digital version is 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.