Navigating the Shoals of U.S. Export Controls

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Subcontracting and Teaming: Procurement Strategies Proving Success for Minority Business Owners

Living Well . . . Achieving Success: A Profile of Desiree Watson

- President & CEO of Wellness Interactive

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6 Questions for Bond Buyers

By Walid Petri

The stock market has taken us on a wild ride the past few years. So the relative stability of bonds may seem enticing. As you weigh how much bond exposure you want, ask yourself six questions. Bond investing basics are simple. When you buy a bond, the bond issuer, either a government or corporation, pays you an agreed-upon rate of interest known as the coupon rate. In addition, you get your original investment back when the bond reaches a maturity date. The questions:

Do you want to go long- or short-term? Normally, longer-term bonds pay higher interest than shorter-term bonds. However, monetary policy and inflation expectations vary with time, so sometimes the normal yield curve may flatten (meaning short- and long-term rates are equal) or invert (short-term rates are higher than long-term rates). When this occurs, it can be very hard to sell a long-term bond because investors can get the same or higher rate investing short-term. The big questions here are: Where do you want to be on the yield curve? How long do you want to invest your money for a given return on your investment?

How much risk do you want to assume? As interest rates go down, the value of a bond goes up, and when interest rates climb, a bond's value falls. If an investor wants less risk, he might choose to buy a short bond, as its value will fluctuate less when interest rates vary. Long bonds usually offer higher interest rates because they typically carry more risk. Historically if an investor wants no risk, short-term U.S. Treasuries were always the consensus best choice. After all, Uncle Sam backs them up. But they pay a comparatively low rate of return. Their safety, though, is no longer assured. The burgeoning U.S. debt makes them riskier.

A bond's duration relates to interest rate risk. It is a measurement of how long it will take for the price of a bond to be recouped by internal cash flow paid out by the bond. A debt instrument with one-year duration is not very sensitive to interest rate fluctuations. But a really long bond with 30-year duration will see its value fluctuate sharply with even a small interest rate change. Generally, a bond that pays a higher interest rate and has a longer term will have a higher duration. As an aside, please note that, although U.S. interest rates are paltry at present: a) They have only one direction to head in the coming years, and that is up; b) other "stable" countries are raising their rates.

How important is the rating to you? Investors usually look to Standard & Poor's or Moody's for bond ratings. Government bonds are perceived as less risky than private sector bonds. Trouble is, the recent financial upheaval was partly rooted in the ratings agencies' failures. They awarded high ratings to mortgage debt that was rotten. Use them as a guide and not gospel. Some bond investors do have relatively high-risk appetites, with some even buying high yield, also known as junk, bonds from troubled firms whose ability to make interest payments is in doubt. The riskier a bond, the higher the interest rate investors demand. Junk bonds are known as below investment grade: For S&P, that's everything rated BB+ and below; for Moody's, Ba1 and down.

Do you want a tax-free or taxable bond? Many federal and municipal bonds are tax-exempt to some degree. Their interest rates are lower than those of corporate bonds. You need to compare muni and corporate bond rates on an after-tax basis. You do this by calculating the tax-equivalent yield, which equals the tax-free interest rate divided by (1 minus the investor's federal tax bracket). Consider two investors. Investor A pays a 25% federal tax rate while Investor B is in the 35% bracket. Should they buy a municipal bond paying 4%, or a highly rated corporate bond paying 6%? The real question becomes: What will they take home after taxes? They run the numbers on the muni bond. Investor A calculates his after-tax yield as 5.33% (4%/(1- 0.25) = 5.33%). Investor B gets 6.15% (4%/(1- 0.35) = 6.15%) after taxes. Investor B chooses the muni. Investor A figures out that the tax exemption saves her less, so she selects a corporate bond and pays taxes on it.

What about inflation fears? Inflation is the enemy of bonds, eroding the value of their principal and interest payments. But there are remedies within the bond world. Treasury Inflation Protected Securities (TIPS) are issued by the U.S. Treasury. Their principal depends upon the Consumer Price Index. Their principal increases with inflation and decreases with deflation. TIPS appeal to investors who fear that inflation could erode the value of their investment. When TIPS mature, you redeem either the securities' original value or their inflation-adjusted value, whichever is greater. Investors who can tolerate varying interest payments may decide to buy a variable-rate bond. The return on these bonds reflects the general level of inflation, and commonly rises with rising interest rates.

Stocks or bonds? Unlike bonds, stocks have the ability to double or triple. Look at Apple (AAPL). But they also can crash, as happened in 2008. Stocks are more transparent than bonds, so bond investors need to do a thorough analysis before buying. Still, you have more choices with bonds. The global bond market is approximately $82.2 trillion; the global stock market, only $37 trillion. Clearly there is an abundance of bonds in varieties that investors can find appropriate for their income needs, tax situation, time horizon and risk tolerance. ■

Fixed-Income Dangers

By Walid Petri

Investing in bonds and other fixed-income holdings is the traditional haven of the risk-averse. But is this too risky? Inflation, even at today's low-single-digit levels, will erode your assets. One way around this, despite higher risk: stocks. For decades, financial institutions have promoted certificates of deposit, savings accounts, money market funds, interest-bearing checking accounts and fixed annuities as riskless or low-risk investment options. This still remains generally sound advice regarding the risk of loss of principal. However, with interest rates at all-time lows, the risk of inflation is growing. With a negligible federal funds interest rate, these conservative options stand little chance of keeping up with inflation. The price of debt has gone up, particularly U.S. and German sovereign debt. In mid-June, the 10-year Treasury yield was 1.59% after touching an all-time low of 1.44%. It has consistently been below 2% since April 26. Overseas, we see Germany's 10-year notes *yielding* around 1.4%.

America had 3% *inflation* in 2011. The annualized inflation rate was down (reportedly) to 2.7% in March 2012. Today, the yield on many CDs, money market funds and interest earning checking accounts can't even keep up with that. I say "reportedly" because the *Consumer Price Index* doesn't tell the whole story of inflation reality – retail gasoline prices rose 9.9% during 2011.

Retirees are feeling the pain of low rates. With the federal funds rate at 0% to 0.25%, a short-term CD earns 0.5% interest today. On average, those who put money in long-term CDs at the end of 2007 (the start of the Great Recession) saw the income off those CDs dwindle by two-thirds by the end of 2011. On paper, *consumer price inflation* is tame, personal incomes are modestly higher and measures of senior poverty are reassuringly low. But in the real world, prices for many consumer items are much higher, especially in poorer neighborhoods without Wal-Marts and other price-conscious retailers. Incomes for many seniors are not rising as their interest income continues to fall and they rightly fear the stock market. A lot of older households are experiencing what can best be called financial exhaustion.

Many older Americans have scrimped during their retirement years to make ends meet. While they make enough money to avoid poverty, they don't have much cushion. Now, with nest eggs depleted and home values still depressed, they are running out of painless financial sacrifices.

In the 1990s and 2000s, the common philosophy was to invest for growth in your thirties and forties and then focus on wealth preservation as you neared retirement. (Of course, back then it was also widely believed that you could count on stock market gains of 10% per year.)

The stock market collapse of the 2000s has, of course, permanently changed this belief in stocks. A generation of people in their fifties and sixties, who still need to accumulate wealth for retirement, also need to start withdrawing from savings for current income. This is truly a sandwich generation. Aside from having to help their children and their aged parents, this group also is caught between their own looming retirement and the need to make up for investment losses of the past decade.

Who could live on the income earned in 1996 or even 2004? Essentially the dilemma of many retirees is: 1) their *certificates of deposit* and money market accounts yield almost nothing, 2) they are withdrawing more than they are earning, 3) their retirement fund is shrinking and 4) they must live on less or without.

Recently reported inflation in the U.S. has averaged between 2% and 4% annually. What if consumer prices rise 4% annually for the next 20 years? At 4% inflation for 20 years, today's dollar will be worth 44 cents in 2032. Today's $1,000 king or queen bed will cost about $2,200 then. Today's $23,000 sedan will run more than $50,000. Beyond prices for gasoline or durable goods, think of the cost for food and health care. Because of this reality, most retirees can't completely refrain from growth investing. They need their portfolios to yield at least 3% and preferably much more. If their portfolios bring home an inadequate yield, they risk losing purchasing power as consumer prices increase at a faster rate than their incomes.

What if you want or need to stay in bonds? Some bond market analysts believe now might be a time to exploit short-term bonds with different maturity dates. As each batch of bonds matures, it is reinvested, thus capturing the latest interest rates. You are less likely to be locked into low yields if current rates increase.

The trade-off is accepting lower interest rates in exchange for a potentially smaller drop in the market value of these securities when rates rise. (Bond rates and prices move in opposite directions.) If you are after higher rates of return from short-duration bonds, look at bonds that are investment-grade but without the top-tier ratings, AAA or AA. If you too expect rates will rise in the near future, using short maturities could position you to get your principal back in the short term. That could give you cash that you could reinvest in response to climbing rates. Still, if you think bond owners are in for pain in the coming years, then you limit yourself to small positions in bonds. **No appetite for risk.** Why would people put their money into an investment offering a 1.5% return for 10 years? In a word, fear. The fear of volatility and a global downturn is so prevalent this spring that many investors are playing not to lose again. Yet when interest rates rise, owners of long-term bonds might find themselves losing out in terms of their portfolio's potential. This is especially worth remembering given the history of the CPI and how inflationary jumps come without much warning.

From 1900 to 1970, inflation averaged about 2.5% in America. Starting in 1970, the annualized inflation rate hit 6%, and by 1979 it was at 13.3%; it didn't moderate until 1982, when it fell to 3.8%. U.S. consumer prices rose by an average of 7.4% annually in the 1970s and 5.1% annually in the 1980s, compared to 2.2% in the 1950s and 2.5% in the 1960s.

According to the Department of Labor and Axa Equitable, since 1950, there were 19 calendar years when the CPI was 2.0% or less. The Standard & Poor 500 stock index was up in 15 of the 19 years, gaining an average of 13.9% per year in total return (stock appreciation plus interest).

All this should tell you one thing: you can't hide in fixed income. Inflation has a powerful cumulative affect no matter how conservatively or aggressively you invest – so you had better seek to at least keep pace with it or better yet seek to beat it. ■