Bond Strategies for Those Fearful of Inflation

By Hildy Richelson and Stan Richelson

Article Highlights

- If you have a bond ladder and you hold bonds to maturity, rising interest rates can provide upside.
- Rising rates allow you to reinvest the proceeds from maturing bonds for a higher yield.
- Focus on cash flow, not the daily mark-to-market gains and losses shown in your bond portfolio statement.

The media warns investors not to buy bonds because inflation is coming, interest rates will rise and the value of bonds will fall.

The brokerage houses "mark to market" your bond portfolio every day, creating an awareness of portfolio valuation in the hopes that you will trade to take gains and sell losses. Depending upon a number of factors, including the frequency with which a particular bond has recently traded, these valuations may be more or less accurate.

In the trading process, you incur substantial costs and the brokers make money. You may or may not make any money. In fact, there have been numerous studies showing that if you trade, you lose money. Daniel Kahneman, the 2002 winner of the Nobel Prize for economics, states in his book "Thinking, Fast and Slow" (Farrar, Straus and Giroux, 2011) that "Many individual investors lose consistently by trading, an achievement that a dart-throwing chimp could not match."

From our perspective, cash flow, not trading gains and losses, is the key consideration for individual investors. However, focusing on cash flow instead of gains and losses requires concentration, because it is a different gauge of success than those normally employed. Cash flow will not start an exciting conversation at a party. When you use cash flow as a measure, sitting in cash waiting for interest rates to go up is not a sensible strategy unless you can correctly forecast that interest rates will go up very soon. If your prognostication is incorrect, you will lose a great deal of cash flow investing at near-zero interest rates in short-term or money market instruments in today's market.

Inflation Is the Upside Case

This is how we think about inflation—and we think about it a lot. For people with bond ladders of individual bonds currently in place, inflation resulting in rising interest rates is the upside case because you can reinvest your maturing bonds and interest payments at a higher rate of return. We ask, "Would you rather reinvest your interest payments and principal at 4% or 6%?" You increase your return by 50% if interest rates were to rise from 4% to 6% over time. If you have a bond ladder in place, then the maturity of your entire bond portfolio shortens every day by one day. As you may have noticed, that adds up!

If interest rates are rising, will the market value of your bonds decline? Yes, they will. However, if you can hold them to maturity, then your bonds will pay off at their face value. And remember, you are buying the bonds for cash flow, not trading when interest rates go up or down. Your cash flow from your portfolio of individual bonds doesn't change when interest rates fluctuate.

The Case for Premium Bonds

If you purchase premium bonds (bonds purchased at a price above their face value), they hold their value better

Bond Strategies for 401(k) Plans

Those of you participating in 401(k) plans, unfortunately, cannot invest in individual bonds in your account. You are given the alternative of investing in bond funds, which are really quasi-stock investments because the bond funds never come due. Having a fixed maturity date is the key feature of an individual bond because you know that on that date the principal will be returned and you will get back the face value of the bond. Bond funds can only return to you the price of the day, which may be more or less than you initially invested. The bonds in the funds do pay interest regularly, which cushions the movement of the price fluctuations.

Bond funds have benefited from declining interest rates, which have pushed bond interest rates down. To give you an idea of how low rates currently are, the average yield to maturity of The Bond Buyer municipal bond index, which is based on 40 long-term bond prices, was 4.48% in the second week of May 2012. The newspaper says its index, which began in July 1984, has never posted a lower weekly average for the yield to maturity. The falling yields and rising prices of funds have attracted large cash inflows from individual investors.

Bond funds have been avid purchasers of premium bonds, which enhances their dividend payouts, along with bond sales that might generate capital gains. Since short-term bond yields are so low, funds have been flowing into intermediate- and long-term bond funds. At the end of 2011, the 10-year AAA municipal bond yielded 1.83% and overall bond mutual funds were up 10.7%, according to The Bond Buyer. Assets continue to flood into bond funds.

While you might expect an increase in price of individual municipal bonds to be reflected in the prices of the funds, this is not always the case. In the second week of May 2012, the 30-year tax-exempt yield hit a new low, and the 10-year yield approached its low. The Bond Buyer observed on May 15, 2012, "iShares S&P National AMT-Free Municipal Bond ETF (MUB) fell 0.88% on Monday, as well as the SPDR Nuveen Barclays Capital Short Term Municipal Bond ETF (SHM), which fell 0.08%" in the same time frame. So the advice to bond fund buyers is that you must "look under the hood" of the municipal bond fund to find out what kinds of bonds it is holding, the names of those bonds and what the credit quality is. Are there any other features of the fund, like fees of any sort, of which you need to be aware? Is the price just a function of the value of the bonds in the fund or is it partially a reflection of the demand for the particular fund?

We believe that individual bonds are better investments than bond funds for many reasons. However, for those investors who can't buy individual bonds in their retirement accounts, here is a way to think about which bond funds to consider:

- Are you concerned about interest rates rising? If so, consider only short-term or intermediate-term bond funds.
- Are you concerned about credit quality? If so, only buy high-quality bond funds, and don't buy junk bond funds, high-yield funds, or emerging market or foreign bond funds denominated in foreign currencies. Look at the portfolio of bonds held by the fund and the ratings of the bonds in the fund.
- Are you concerned about high volatility? If so, don't buy funds that hold bonds denominated in a foreign currency. The foreign currency may produce big gains or big losses. Consider bond index funds to provide wide diversification.
- Are you concerned about high fees? Consider funds managed by Vanguard and Fidelity. They have no loads and reasonable fees.
- Do you want big-name managers with good records who manage for total return? Consider Pimco funds headed by Bill Gross and DoubleLine funds headed by Jeffrey Gundlach.

Whatever you decide, realize that when interest rates rise, the value of your bond fund will decline and that bond funds will never come due. Like any other fund, there is no guarantee that your investment will be intact just because you chose to invest in a bond fund. It will fluctuate in value daily, and at some point may become quite volatile.

in a rising interest rate scenario. The higher coupon rate that is the essence of premium bonds means that you receive a return of a portion of your principal with each interest payment. In this way, an investor in premium bonds will recoup the amount they paid in excess of par via the higher coupon payments. The technical term for this is amortization, the return of both principal and interest at the same time. This higher cash flow will enable you to reinvest more money at a higher interest rate if interest rates rise.

Investors who are seeking a pure interest stream to provide a cash flow in lieu of a paycheck tend not to like premium bonds if they want to protect their principal. It may be difficult to figure out how much is a return of principal and how much is interest, though you

Be Wary of Esoteric Securitized Bonds

Which would you rather have, a promise to pay or cash in hand? In 1997 David Bowie decided that he would rather have the cash in hand than wait for the royalties from his record sales. He sold his intellectual property. Unfortunately for bondholders, the record business went into a slump and the value of his bonds was downgraded, but his investors got their money back.

This began the process of securitization, whereby the banks sold bonds backed by revenues from movie deals, drugs, real estate time shares and franchises. Though some of the names may be familiar to the average consumer, the bonds may be considered junk bonds by the rating agencies. In a low-interest-rate environment, where 10-year bonds yield 2% and 30-year bonds only 3.15%, yields on securitized paper can top 5% on bonds backed by pizza that you eat and movies that you watch. And familiarity can lead to trouble.

Recently, the bottom fell out of the mortgage market. The banks figured out that they could package mortgages they had on their books and sell them. As we found out, this was very advantageous because they were able to write mortgages without too much concern. The mortgages became other people's problems, and the banks suffered as well because they forgot the junk they put in and ate their own cooking. For example, if a bank sells a mortgage for $100,000, and does the same for 10,000 people, they have now lent $1 billion. That is bundled up and sold, and they will get a mixture of principal and interest back over the next 25 years, unless some of the mortgages are not paid and there is less cash to flow through to the bondholders.

As one commentator for The Wall Street Journal said: Fool me once, shame on Wall Street. Fool me twice, shame on me.

can make a rough guess by multiplying your average yield to maturity times the face value of the bonds. So, for example, if your yield-to-worst call is 3% and your face value is $1 million, then you can assume that your interest payment total is $30,000, though the cash flow might be much higher if you purchased premium bonds. If you consume some of the principal along with the interest, then the bond functions more like an annuity. In an annuity, you are provided with a higher income stream because you are consuming some of your principal and making the insurance company your heir for the remainder of your unconsumed assets.

One of the advantages of premium bonds in a declining interest rate environment is that the bonds rapidly appreciate. This is especially so if the issuer pre-refunds the bonds by setting aside funds in an escrow account to pay all interest and principal until the first call date. In effect, the bonds will now be redeemed on that first call date. This can result in significant and immediate appreciation—and the possibility of a capital gain if you decide to sell.

Take, for example, Ohio State Water Development bonds for clean drinking water. They have a 5% coupon and had a final maturity of 2026 until they were pre-refunded to their first call date in 2018. In April 2012, the bonds' price was 123.074, or $1,230.74 for each $1,000 of face value. If the bonds were sold at that price, the yield to maturity would be 1.089%. This means that if you did not own this bond but were to buy it currently at this price, the yield to maturity that you would earn would be 1.089%.

On first look, it appeared that selling these bonds and taking the gain was the best course of action. On second thought, there were other considerations. First, the bonds were paying a cash flow of 5%, not easy to reproduce in today's market. Second, we may be at an interest rate bottom. We don't know what will happen, but if we were to reinvest the gains in new bonds, the maturity date would have to be around 20 years to get an adequate return. Interest rates might rise in the next six years when the bonds were to mature.

We decided we would rather have the higher cash flow and the principal back from the bonds for reinvestment at the hoped-for higher rates than have a current gain. We felt that long-term rates were not sufficiently attractive for this trade (selling the bonds) because the yield curve is not steep enough: Long-term rates need to be around 300 basis points more than the selling yield (in this case 1.089%) to make the trade sensible after taking into account the tax payable on the gain.

We did take the opportunity to sell less-credit-worthy bonds. Due to their high coupons and the market hunger for high yields, their prices were also up. We sold Buckeye Tobacco Settlement Financing bonds, rated B3 by Moody's and B– by Standard & Poor's, for $755 per bond. Considering that the bonds might pay $0.20 on the dollar if they defaulted, we were very pleased not to have to take that risk. This is an ideal time to sell low-rated junk bonds at a good price and to protect your capital.

The Cost of Waiting

Keep in mind that there is a cost associated with waiting to invest that should be factored into your investment process.

Five years ago, advisers who believed that interest rates had nowhere to go but up kept their clients' funds in one-year to five-year bond ladders. Five years later, they are still waiting for inflation and rising interest rates to bail them out. Instead of having cash flow between 4% and 5%, which was available to them in bonds at the time, they had to accept a very low rate of return while they were waiting. The money invested earned less than 1% for five years. It will be many years, if ever, before those lost cash flow payments are recouped.

We discuss this subject in our article "The Short-Term Route to Long-Term Failure" (published by AdvisorPerspectives, an e-publication for advisers) that is posted on our website at www.allbondportfolios.com.

Building a Ladder in a Low-Interest-Rate Environment

If you don't have a bond ladder and you wish to start one, you may, at first, be discouraged by the low yields on bonds coming due within 10 years. After all, advisers recommend ladders that are usually five to 10 years in length. That means that your longest maturity would be in the year 2022, and your average yield would be about 1%. Because most advisers are afraid of rising interest rates, this is what they would recommend. Then they would suggest market timing and selling to move assets from short or intermediate to longer-term bonds as rates rise.

Instead, we recommend that you first think about when you will need access to your cash. You want to be sure that you have resources when you need them without having to sell into unknown market conditions.

Then, we suggest that if you can lock in 3% to 4%, you are 2% to 3% ahead of the game. You can do that by purchasing longer-term bonds. While we prefer a ladder that targets years when you may need your funds (for college for example) or a ladder that has bonds maturing in every year, we have to deal with our current reality. Longer-term bonds pay substantially more both to the call and to maturity. They provide you with a higher cash flow to reinvest at higher rates if and when higher rates appear and more funds to live on if that is what you need. We hope that you will always have interest that you can reinvest at higher rates if and when they appear.

Also, the yield curve is not fixed but rather fluid, so short-term and intermediate-term bond yields can rise when the Federal Reserve decides to raise interest rates, while long-term yields may fall. As the yield curve changes shape, you will have the opportunity to purchase shorter-maturity bonds at higher rates, while the life span of your longer-maturity bonds will decline with each passing year. No one has a crystal ball telling them when rates are going to rise. It is an unknown.

When you read that interest rates have nowhere to go but up, remember that the stock market and real estate prices were inflated in Japan between 1986 and 1991, followed by a deflation of those markets and very low interest rates for a decade. Though the markets gained some strength after 2003, they were once again pummeled by the collapse of our own real estate and stock markets. The benchmark interest rate in Japan in 1999 was 0.0% and in 2012 it is again in the same place. The average interest rate in Japan from 1972 to 2010 was 3.5%, with a high of 9.0% in 1973, according to data published by Trading Economics. The Bank of Japan notes that "Overseas economies on the whole still have not emerged from a deceleration phase," and, in particular, that the Japanese economy "faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability."

The Possibility of Deflation

Few commentators take into account the possibility of deflation. We are in an unwinding of the leverage that has engorged our economic system. The jobs report on May 4, 2012, stated that 115,000 new jobs were added in March 2012, far lower than the 165,000 the market was expecting. One reason for the poor jobs report is this unwinding of leverage. For example, states and municipalities must shed jobs and bring down costs in order to put their economic houses in order. In particular, they must reduce pension and health care costs, which will dip into the pockets of many American workers. This is going to unfold slowly and will be a big damper on inflation.

At the end of 2012, after our national elections, the U.S. Congress will have to decide whether to allow the expiration of a host of tax cuts and other measures, creating a fiscal drag on the economy. Retaining the tax cuts will result in a further ballooning of the national debt and pressure to once again raise the debt ceiling. There are also planned spending cuts that are supposed to kick in around that time. Both higher taxes and already programmed spending cuts will result in a huge fiscal drag on the economy "of 3.5% to 5%," according to David Reilly of The Wall Street Journal (April 9, 2012). Spending cuts at the state and local levels "would add an additional 0.5% hit."

The European economy is in shambles: Portugal, Ireland, Italy, Spain, Greece and even France all have enormous debt. Surges in Spanish and Italian bond yields rock the U.S. stock market. The European banks must increase their capital requirements as outlined in the Basel III accord. If the requirements of that summit had been in place in June 2011, more than 20% of Europe's biggest banks would have failed to meet the Tier-1 capital requirements, according the European Banking Authority per Bloomberg. Instead, these requirements will be phased in over a number of years. All in all, leverage and debt must be curtailed as these economies retrench.

While there may be inflation in our future, it may not surface any time soon. There is a cost to waiting, and the loss of cash flow while waiting may be substantial.

Bond Mutual Fund and ETF Strategies

While we recommend purchasing individual bonds to build a bond ladder that will produce cash flow and a return of principal, many investors prefer to purchase bond mutual funds and exchange-traded funds (ETFs). These funds are quasi-stock investments because, though they own bonds, the funds never come due. The funds must maintain the average maturity range described by their charters. The funds trade bonds and buy new ones. They pay out dividends, composed of both capital gains and interest. There are fees, costs and taxes associated with the funds or ETFs. Bond fund managers may purchase lower-rated bonds in order to boost their yield, so that the fund will be more attractive than its competitors. It is hard to know exactly what the quoted yields mean or if they are comparable to one another.

Also, a significant current risk is that "hot money" is ready to jump out of the funds as soon as inflation rears its head, or on any other provocation. At the end of 2010, bond funds held $240 billion, according to The Bond Buyer. The financial newspaper further observed that with predictions of widespread municipal bond defaults, $50 billion gushed out of muni bond funds in early 2011, only to seep back to $210 billion by March 2011 when it appeared that the predictions were overblown. Then, contrary to the pundits' predictions that interest rates could only go up and muni prices down, municipal bond prices rose along with those of Treasury bonds, achieving a 10.7% total return. This attracted even more money to muni bonds because investors like to go with winning portfolios, even though it is often the losing portfolios that are poised to gain when the tide changes. Institutional investors are closely tracking the ebb and flow of municipal bond mutual funds, while you as an individual investor will get that information only after the fact.

Moves such as these can result in losses and/or short- or long-term capital gains taxes. In order to meet redemptions, the funds must sell their best bonds to get the best prices. That can reduce the credit quality of the funds if they must sell quickly. The individual investor notoriously mistimes buys and sells, as we said at the outset.

With ETFs specifically, there are additional concerns. It is not easy for a bond exchange-traded fund to replicate a bond index because some bonds do not trade at all and others are thinly traded. Since an ETF cannot purchase all the bonds in the index it tracks, the ETF must resort to 'sampling' the bonds held in the index. As a result, it may not accurately track the index, if there is one at all. Hence, there may be tracking errors. Tracking errors have been reported to be as wide as 3% on some funds, while Morningstar has reported tracking errors of between 1% and 2%. Another problem is that most ETFs use a market-cap weighting method, "which means that companies that issue the most debt are the largest parts of the index," according to Jason Kephart of InvestmentNews. Having the most debt does not mean that you are likely to have the best credit reports.

Our Personal Investment Strategy

We are buying individual tax-free municipal bonds for our personal accounts as our cash flow becomes available. We are not sitting on cash to earn less than 1%. With each investment, we have been making a minimum of +3% if the bonds are called at their first call date and +4% if the bonds are not called. Can interest rates move lower? We are sure that they can.

We will not lose any principal through bad timing, because we intend to hold our bonds until their maturity date. Every year, our bonds are one year closer to maturity. Our longer-maturity bonds gradually become intermediate bonds, and the intermediate-term ones become short-term. Unlike bond funds, which must keep their bonds within a specified maturity range, individual bonds shift their place in the yield curve.

We will not pay any federal income taxes on our tax-free municipal bonds during the period the bonds are outstanding. We will not worry about default, because all of our bonds are high-quality bonds. We will reinvest the cash flow at the current market rates. We will track our cash flow and continue to add to it.

This is what we recommend to our clients. This simple strategy will result in the growth of bond portfolios as a result of compounding of interest and the preservation of principal. It may even result in financial independence. ▲

Hildy Richelson and Stan Richelson head Scarsdale Investment Group, a registered investment adviser based in Blue Bell, Pennsylvania, that specializes in fixed-income investments. The Richelsons are co-authors of several books on bonds, including "Bonds: The Unbeaten Path to Secure Investment Growth," Second Edition (John Wiley & Sons, 2011). For more on the authors, go to www.aaii.com/authors/stan-richelson and www.aaii.com/authors/hildy-richelson.