BONDS

Scarsdale Investment Group, Ltd.

All Bond Portfolios

Should You Buy Bonds when Inflation Rumbles?

Hildy Richelson and Stan Richelson, Scarsdale Newsletter 8-19-2021

While interest rates continue to decline, our strategy for bond investing has stayed the same. We purchase high quality bonds to create a cash flow to support your lifestyles. We protect your principal from possible catastrophic impacts.

This is not a perfect solution; we all know that. The media reports on the rumblings of inflation that will eat up your returns. Fear mongering sells papers. The media likes to focus on the impact of inflation on bonds, neglecting its equally deleterious effect on stocks because that is an inconvenient truth.

Behind those inflation articles are the short sellers who would like to create fear for their own advantage. The article "Skeptics of Low Rates Drive Up Treasuries "[i] describes how fund managers shorted long-term bonds and loaded up on shorter-maturity bonds to ready themselves for the spike in yields. When interest rates did not respond as they anticipated, they had to cover their positions and buy longer-term bonds, cementing the lower rates. Did you take the bait and bite the hook, waiting for that interest rate spike?

There are so many factors to consider in making financial decision. The information can be dizzying. For example, non-farm payrolls are up. Bottlenecks are creating a temporary interest rate spike. Every day there are new factors to ponder.

To keep from being swept away by the media assaults, you need to focus on your personal objectives. Aside from having 'more,' which seems to be what the journalists and copy editors like to provide as a goal, what is your own personal truth? What is it that will make you happy and bring you peace?

We buy the highest quality bonds at the best return that we can find. We Know that we don't know the direction of interest rates, even when they are "low". We don't know what low is since that denotes that interest rates will be higher at some point in the future. High and low are comparative terms, but they miss the point that sitting in cash you are earning the lowest return possible.

Interest rates are still zero or negative in many European countries and Japan. When you accumulate cash, you are concluding that you "know" the direction of interest rates. However, we do know one thing, if you don't invest today, you will lose that day's interest and may not make it up in the future. Thus, there is a cost and money on the table when you conclude that interest rates are low and they will be higher in the future. You will also lose the cash flow and compounding available by reinvesting.

We buy 4% and 5% coupons when available in high quality credits and 3% otherwise. This provides a current return of more than 3% tax-free for 9 or 10 years. The current return is the coupon/price of the bond. If for example a bond had a coupon of 4% and a price of 120 (or $1,200), you divide the coupon by the price. For example: 4/120 x 100=3.33%. The cash flow from a 4% bond is $40 per $1000 invested, and unlike annuities, you don't lose your principal.

Buying today is a recognition that we don't know what interest rates will be in the future. If interest rates go up in the near future, we will be pleased to reinvest that 3% + cash flow in the then higher returns.

We are not frozen by "low" interest rates. We move forward.

Here is a thought experiment: what if interest rates were 50 basis points higher today? Would you then invest your cash, or would you redefine what low is? If would reinvest, should you be frozen by the possible "loss" of higher interest rates which are not much higher? What say you? Where is your comfort level? Is it based on logic or emotion? There is always higher and lower.

Media hammers home that you should be a trader, not a buy and hold guy. Media does not see any benefit in being conservative and protecting your principal. A thirty-to-fifty percent drop in market valuations is something we have seen before and may see again. Protecting at least some of your principal in high quality bonds is a defensive measure that will help you sleep at night.

[i] Sam Goldfarb. “Skeptics of Low Rates Drive Up Treasurys,” The Wall Street Journal, August 10,2021.