Unconventional Monetary Policy and Bond Investing

March 2012 Client Letter

Monetary policy has been one of the most influential forces in financial markets over recent years. The Fed has shifted policy from the conventional (changing the fed funds rate) to the unconventional (money printing and communications). Unconventional policy maneuvers have proven to be a potent force in financial markets. This is especially true for the bond market, where Fed action has the most immediate and direct impact.

The Fed's latest was announced earlier this year. In January, it pledged to hold short-term interest rates at 0% until late 2014—more than a year longer than the market had anticipated.

The surprise extension of the 0%-interest-rate policy pushed Treasury rates down across the maturity spectrum. Five-year T-note yields dipped as low as 0.75% in the days following the announcement—more than two percentage points below the rate of inflation. Yields on our favored high-quality short-term corporate bonds fell in sympathy with falling Treasury yields. The more upbeat tone of recent U.S. economic data has also helped push down high-quality corporate bond yields as investors demand less compensation for taking on credit risk. The yield on the Merrill Lynch 1-2 year AA-AAA index has dropped below 1%.

With yields of less than 1%, high-grade short corporates have become less appealing. To offset the lower yield, we are seeking areas of the lower-rated (BBB and below) corporate bond market. We have an especially favorable view of high-yield bonds. With a shortage of yield in the bond market and rising risk appetite, a 6-7% yield from high-yield debt looks attractive.

To gain exposure to high-yield bonds, we recently began purchasing SPDR Barclays High Yield Bond ETF (JNK). JNK offers exposure to a diversified basket of high-yield bonds in a liquid exchange-traded vehicle. The yield on the SPDR Barclays High Yield Bond ETF is currently 7%.

Most often we favor traditional bond mutual funds over bond exchange-traded funds (ETFs). Why? Bond ETFs have a tendency to trade at prices above or below net asset value (NAV). With the purchase of JNK, we are looking past the NAV issue because many of the traditional bond mutual funds we favor have stiff redemption fees that can remain in effect for up to a year. In today's fast-moving and volatile markets, it is our view most bond ETFs provide a greater opportunity to maximize return in high-yield bonds than traditional bond funds.

In conjunction with the purchase of the SDPR High Yield ETF, we also added bond positions in Frontier Communications and Arcelor Mittal. Frontier Communications is the nation's largest provider of communications services focused on rural America. The Frontier bonds we purchased are due in April of 2017 and they are rated Ba2/BB by Moody's and S&P. The bonds were acquired at a yield to maturity of 7.74% in most portfolios.

Arcelor Mittal Bonds

Arcelor Mittal isn't a household name, but it should be. Arcelor is the world's leading steel production and mining outfit, with annual production capacity of 100 million tons. The company has 260,000 employees spread across 60 different countries. Arcelor is the leader in all major steel markets, including automotive, construction, household appliance, and packaging. In 2011, the company produced around

6% of the world's steel. The Arcelor bonds we bought are due in February of 2017, and they are rated Baa3/BBB- by Moody's and S&P. We purchased the bonds at a yield to maturity of about 4.5%.

Another recent addition to fixed-income portfolios is two-year U.S. Treasury zero-coupon bonds. We purchased two-year zeros partly to offset the additional credit risk we are taking with high-yield bonds.

Zeros are Treasury bonds that do not pay income. Instead they are issued at a discount to face value. By example, if an investor purchased a one-year zero with a 5% interest rate, he would pay $952.30. In one year, the bond would mature and the investor would receive $1,000—a 5% return (($1,000 – $952.30) / $952.30 = 5%).

Our zeros strategy is to maximize capital gains over an entire interest rate cycle. With rates currently flat, we favor short-maturity zeros. As the rate cycle evolves and yields rise, we anticipate moving out on the yield curve to longer, higher-yielding zeros that offer greater potential for capital gains.

For retired investors and those nearing retirement, we have long advocated a balanced approach to investing. Balanced portfolios tend to hold up better than single-asset-class portfolios in a variety of market climates. When writing about balanced portfolios, we usually discuss the benefits of adding bonds to an equity portfolio. But the current prolonged period of zero interest rates and the prospect of two and a half more years of the same provide the opportunity to focus on the benefits of owning equities.

While an all-bond portfolio may experience lower volatility than a balanced portfolio, it suffers from greater inflation and income risk. In the current environment, with intermediate-term Treasuries yielding 1% and inflation running near 3%, an all-Treasury portfolio generates inadequate income and sacrifices purchasing power.

Assuming a standard 4% withdrawal rate, the purchasing power of a Treasury-only portfolio yielding 1% would fall 6% per year (3% from taking more income than the portfolio generates and 3% from inflation). It wouldn't take long to decimate the purchasing power of a portfolio at a 6% depletion rate.

Stocks, and more specifically dividend-paying stocks, can help offset the elevated income and longevity risks that a bond-only portfolio faces.

Dividend-paying stocks are the focus of our Retirement Compounders portfolios (RCs). With the RCs, our goal is to generate a sustainable and steady stream of income that keeps pace with inflation. We make no attempt to “beat the market.” Our objective is to build and protect capital and provide a stream of income during retirement.

After two vicious bear markets and a prolonged period of ultralow interest rates, many investors seem to be rediscovering the merits of dividends. Asset flows into dividend-focused funds have increased markedly in recent years. But many of the popular dividend funds buy only U.S. stocks, and often pay scant attention to maximizing portfolio yield. The Fidelity Strategic Dividend and Income Fund and the Vanguard Equity Income Fund come to mind as two relevant examples.

Both funds claim to focus on generating dividend income, but the Fidelity fund yields only 2.68% and the Vanguard fund yields 2.16%—not much more than the 2% yield on the S&P 500. There are of course some dividend funds that seek to maximize yield, but here we find that too much emphasis is placed on yield and not enough on dividend growth.

With the RCs, we take a different approach. We craft globally diversified portfolios of businesses we view as stable that sell essential goods and services in industries with high barriers to entry. We purchase exactly 32 positions to ensure discipline. And we favor companies with strong balance sheets or readily available access to capital. Most importantly, we buy only dividend-paying companies and strongly favor those with a history of consistent dividend increases. Today our RCs yield about 4.5%—more than double the current market yield—and the average five-year dividend growth rate of our portfolio companies is 4.5%. The combination of a high yield today and dividend growth tomorrow should be compelling for investors in or nearing retirement.

Have a good month, and as always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Sincerely,

Matthew A. Young
President and Chief Executive Officer

P.S. The Cato Institute's Chris Edwards effectively argues that House Budget Committee Chairman Paul Ryan's annual budget blueprint is hardly a slash, burn, and pillage of the government's safety net. As a share of GDP, the Ryan budget would trim outlays from 23.4% this year to 19.8% by 2022. That reduction would simply bring spending back to around the normal historical level. And note that spending would still be higher than the 18.2% achieved in the last two years under President Clinton.

P.P.S. Last year, our favored consumer staples and utilities were the two best-performing sectors in the S&P 500. YTD, staples and utilities are out of favor as the more speculative sectors of the market head higher. Regardless of the shift, we continue to favor the defensive characteristics of consumer staples and utilities in the current environment.

P.P.P.S. The Fed has flooded world markets with excessive liquidity. In our view, interest rates are at manipulated and artificially low levels.

Eventually, rates should revert back to more normal levels. They could even overshoot dramatically, causing disruption for long-bond holders, speculative equity investors, and the U.S. dollar.