BONDS

Scarsdale Investment Group, Ltd.

All Bond Portfolios

<u>WHAT IF INTEREST RATES GO UP?</u>

July 8, 2015

There has been a great deal of gnashing of teeth and other serious worrying about the consequences to a bond portfolio of rising interest rates. Everyone knows that if interest rates go up, the value of bonds go down. This perpetual worrying is good fodder for the media, but our reaction is: "What, me worry?" [i]

At Scarsdale Investment Group, Ltd. we are not worried about rising interest. If interest rates rise, we can buy bonds at higher rates and thereby create a larger cash flow. Why is our strategy so different?

Create Cash Flow, Not Market Timing

The Scarsdale strategy is based on a buy and hold philosophy, and views cash flow as the major objective. The question we ask is: How much cash flow will a given portfolio generate? The Scarsdale strategy does not concern itself with paper gains and losses because it is our intention to hold bonds until they come due at their face value. High quality bonds will **automatically return the invested principal**.

Our individual clients can measure their comfort level by comparing their cash needs (their budget) to how much cash flow their bond portfolio produces. When their cash flow from bonds exceeds their budgeted needs they can declare themselves financially independent. There is no other asset class that can be used to create such a reliable financial plan for individual investors.

General Financial Planning Advice Re: Bonds

With this background in mind, we turn to "Braced for a Bond Slump," an article published in *Financial Planning Magazine*, June 2015, written by John

F. Wasik (see link below). Wasik reviews advisors' approaches to dealing with the issue of rising interest rates. They fall into the following categories:

- Keep your bond investments between two to five years.
- Invest in high yield and floating rate bonds.
- Invest in a total return bond fund.

Invest in Individual Bonds or Bond Funds Coming Due In Less Than 5 Years

One typical advisor kept his bond investments to two years, to protect against investment losses from rising interest rates. This advisor did not mention the opportunity cost resulting from the failure to earn compounding interest by investing in longer term bonds at higher returns. Advisors explain that this enables them to reposition the cash in other investments, and for investors to use returning principal for current expenses.

For example, selected yields on a high quality tax-free muni bond in June 2015, for the City of McKinney, Texas (Aa1 Moody's, AAA S&P), are shown in the table below.

Maturity	Yield
2016	0.46
2017	0.89
2018	1.24
2019	1.47
2020	1.72

Maturity	Yield to 2025 Call	Yield to Maturity
2025	2.63	2.63
2030	3.1	3.587
2035	3.36	3.986

Using the above table, a two-year ladder might return .675% and a five-year ladder might return 1.156%. This strategy ignores the opportunity cost to earn a higher return.

In year 20 of the same McKinney issue, the yield-to-maturity was 3.986%, an increase of 2.83% over the five year ladder in the above table (1.156%). If the bonds were called in year ten, the yield would be 3.63%, for an increased yield of 2.247%.[ii] See our article: "*The Short-Term Route to Long-Term Failure*" below.

The safe withdrawal rate in the past was often considered to be 4 percent and now is closer to 3 percent, yet here is a high quality bond providing well above the three percent return and close to 4 percent if it is not called prior to maturity.

Invest in High Yield: Dividend Paying Funds and Stocks; Corporate Bonds

A second proposed bond solution mentioned by John Wasik is to invest in single preferred stocks, floating-rate funds, high-yield municipal funds, total return bond funds and high-yield corporate bonds. Unfortunately these kinds of investments are generally of low quality and will be hard hit by rising interest rates. Low credits suffer as liquidity dries up. As interest rates rise, floating-rate funds generally fail to float immediately, and the spreads between high quality and low quality bonds widens. There may also be defaults.

Bond funds are quasi-stock investments because the bonds never come due. They pay dividends, not interest to their investors, reflecting that the payouts are part interest and part return of principal. You might also want to look under the hood if you own a bond fund. For example, Oppenheimer's tax-free Rochester Maryland Fund held 45.3 % of Puerto Rico bonds as of May 31, 2015.[iii] The state of Maryland is rated triple-A, while Puerto Rico's bonds are rated junk and the Governor is threatening default on the Commonwealth's bonds in June 2015. If your bond fund is yielding significantly more, you might want to know why. See our article "*Buy Bonds and Not Bond Funds*" below.

Are Rising Interest Rates a Sure Thing?

While interest rates may rise and the prices of bonds may fall, there is no set timetable for this to occur. While low quality bonds probably will be hard hit by the Federal Reserve's proposed interest rate hikes, high quality municipal bonds may not follow the same trajectory. In addition, long term rates may decline as the market realizes that inflation will not get out-of-hand.

The Scarsdale general solution to rising and falling interest rates is a custom bond ladder. Contrary to the popular view: **Bond ladders are not fixed**

and stagnant. They are constantly changing. Bonds are called away. Bonds come due. Between both types of redemptions, clients will have principal returned in addition to the interest payments from the bonds. Wasik quotes *Stan Richelson* as saying: “We try to get our clients out of the mark-to-market paradigm and focus on cash flow.”

Wasik concludes that: “predictions of bond market declines in the coming year may be overblown.” Even if rates do move higher initially, such a shift may not be followed by a prolonged bear market in bonds.” The common definition of a ‘bear market’ is that interest rates are rising and prices are falling. The reason he does not think this would happened is three fold:

- Secular stagnation - sluggish employment and economic growth.
- Janet Yellen, Federal Reserve Chairwoman, stated the Federal Reserve might need “to keep real interest rates persistently quite low relative to historical norms...”
- Slower corporate growth.

The conundrum of what to do when interest rates are rising makes good press, but may not reflect the needs of individual investors or small community banks and credit unions that are looking to secure a return on capital and a good cash flow from bond investments. In the financial planning community the consensus view currently is that any changes in interest rates will occur slowly, over the long term. *Stan* is quoted as saying: “Bond volatility is only relevant in bond ETFs and mutual funds. We try to get our clients out of the mark-to-market paradigm and focus on cash flow.”

Wasik article: http://www.financial-planning.com/news/investment_insights/brace-clients-for-a-bond-slump-2693002-1.html

Braced for a bond slump: http://www.financial-planning.com/news/investment_insights/brace-clients-for-a-bond-slump-2693002-1.html

Buy Bonds and not Bond Funds:
http://www.allbondportfolios.com/bond_article_11_24_09.pdf

The Short Term Route to Long Term Failure:
http://www.allbondportfolios.com/short_term_to_long_term_failure.pdf

The Bonds that Broke Puerto Rico:
http://www.nytimes.com/2015/07/01/business/dealbook/the-bonds-that-broke-puerto-rico.html?smprod=nytcore-iphone&smid=nytcore-iphone-share&_r=0

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[i] Alfred E. Neuman, *Mad Magazine.*
[ii] The McKinney Texas deal was sold on June 23, 2016.
[iii] Mary Williams Walsh. "The Bonds that Broke Puerto Rico," *The New York Times,* 7/1/2015.