

Lowly Analyst Free Newsletter

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CurtFey.com

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The Market

Stocks are in a bear market rally. Bear markets typically have a number of short term rallies. The fundamental problems of the US economy are not being solved. Our regulations permit rampant speculations by institutions, pension funds, and hedge funds.

The government doesn't want to admit that we are in a recession, since the data does not yet meet the official criteria. The jobless rate is getting worse. It hit a six-year high of 5.7% in July. The consumer price index rose 5% in June from a year earlier: a 17 year high. Wages are up only 3.4% from a year ago. Energy costs are so high that they change economic behavior such as driving and car purchases. Fortunately commodity costs have temporarily eased, but earning estimates are still shrinking. Our financial system is shaky with about 100 banks being on the brink of failure. The federal government has such large commitments to the mortgage market and to banks that if it were a private firm it would be insolvent.

We are getting more dependent on foreign countries. 45% of sales of S&P 500 companies are now to foreigners. All these problems will eventually be reflected in the stock market.

Asset Classes. For the past month: Micro up 5%, Small Value 2%, Small Growth-1%, Large Value. -1%, Mid Value -1%, Large Growth -2%, Mid Growth -4%.

Sector ETFs: For the past month Biotech up 16%, Fin Service 10%, RAFI Hlth Care 5, Aerospace 4%, Consumer Goods 4%, Transportation 3%, Real Estate 3%, RAFI Industrials 2%, Silver 2%, Semiconductors 1%, RAFI Basic Materials 1%, RAFI Consumer Services 1%, Technology 1%, International Communications -1%, Euro -1%, Gold -1%, Clean Energy -3%, Covered Calls -3%, RAFI Utilities -5%, Agribusiness -10% Oil -12%, International Energy -12%, GSCI Commodities -13%,%.

Foreign Investing: For the past month: India up 8%, China 2%, So Africa 1%, Euro 50 0%, Switzerland -1%, US -1%, Singapore -1%, Germany -1%, Sweden-1%, Spain -1%, Hong Kong -1%, Malaysia -2%, France -2%, So Korea -2%, Europe 350 -3%, Foreign Large Dividend -3%, World -US -4%, Japan -4%, United Kingdom -4%, Pacific -J -5%, Mexico -5%,Canada 6%, Australia -6%,BRIC -7%, Latin America -8%, Brazil -9%, Russia -16%

Investing for Income II

1. Introduction

This is a continuation of the discussion in the June newsletter. In that newsletter we had many tables and graphs but little text. This newsletter provides text and some additional information.

Bond Fundamentals

A fixed income portfolio should be diversified. It is best to consider the following categories:

Treasury Inflation Protected Bonds, TIPS

Short Term

Intermediate Term

International/Global Bonds

High Yield Bonds

High Yielding Stocks

Covered Bonds

GNMA

Municipal bonds

A bond is a negotiable instrument that documents a legal agreement to compensate the lender through periodic payments of interest and principal. At maturity the bond can be redeemed at a specified price. But between issuance and redemption, bonds can sell above or below the redemption price.

The issuer can have the right to call the bond for redemption at certain times at specified prices. The owner of a bond may have the right to sell (put) the bond to the issuer at certain times at specified prices. The put and call are rights that need not be exercised by the owner of the right.

2. Bond Risks

Bonds have a number of risks that affect the value of the bond. There is the risk of interest rate changing and the risk of the issuer's credit changing. There is also the reinvestment risk. A bond may pay a 5% interest. The owner may want to reinvest the interest again at 5% or more, but can reinvest only the interest at the going rate that can be less than 5%.

There is also the risk of inflation. Bonds, except for inflation-protected bonds, do not adjust principal and interest to inflation.

There is also the risk of changing tax rates for bond issuer and bond holder, and there is a very real liquidity risk. Bonds, except for Sovereign Bonds like US treasuries, trade very rarely and usually in multimillion

dollar amounts. If you want to sell a small amount of bonds, you may get only a very low price.

Just as in stocks, there are risks that can be diversified and risks specifically to a particular bond that cannot be diversified, such as the risk of default on interest or principal.

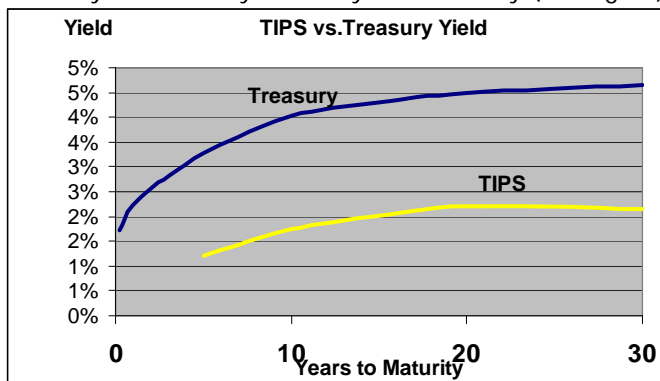
Relative prices of bonds vary continually. Bonds are often used to reduce the risk of a portfolio of stocks. To get the maximum benefits of diversification, asset returns should move differently. One asset should move up when another goes down; the assets should be uncorrelated.

The correlation of bonds and stocks depends on many factors among them maturity and quality. The lowest correlation, maximum diversification effect is achieved by short-term high quality bonds. Including high grade short-term international bonds further increases the diversification. When the dollar is low, foreign bonds can be attractive.

Treasury Inflation Protected Bonds, TIPS

TIPS are securities with a principal and interest that are both adjusted for inflation according to the Consumer Price Index. The adjustment can be up or down. At maturity, the payment is the larger of the original or the adjusted principal. The inflation adjusted interest is paid on the inflation adjusted principal. For example, if the initial coupon is 3% the principal is \$100 and the inflation has increased by 4%, then the principal increases to 104 and the interest is $3\% \times 1.04 = 3.12\%$ of \$104 principal = 3.24% of the original \$100. In other words the interest on the original \$100 increases with the square of the change in inflation Taxes have to be paid on the change in principal even though that change is not paid out until maturity. Therefore TIPS should be held in a tax deferred account.

TIPS are sold in multiples of \$100 with maturities 5, 10, and 30 years. Their yields vary with maturity (see figure).



In addition to TIPS there are other inflation protected securities such as international government inflation-protected bonds (WIP).

There are TIPS mutual funds. Currently TIPS Funds and ETF's paying interest at 4.8%. The principal goes up and down and has done both in recent months. In the past, the US has had both inflation and deflation. The last time the consumer price index went down was in 1955. It is unlikely that the CPI will go down. Bonds fluctuate inversely with interest rates. If the interest rate goes up, the price of bonds goes down.

The attractiveness of TIPS is a function of real interest rates (nominal interest rate minus inflation). Recent TIPS were issued at 3.625% and inflation was 4.176% at a real interest rate of minus 0.551%. The benefits of TIPS vary with maturity. TIPS generally are less volatile than Treasuries.

For deciding how much of fixed income you should hold in inflation protected bonds you can construct a decision table that depends on your risk tolerance. There is no correct answer. An example is below. Currently inflation protected bonds are not a good choice.

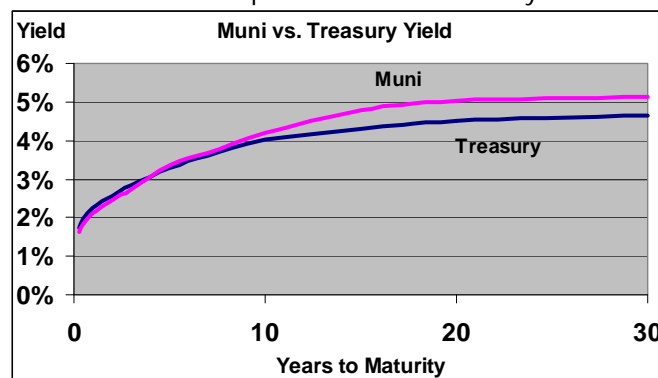
Inflation Protected Bonds Decision

Real Interest Rate	Inflation Protected Bonds
< 1%	0%
1-2%	0-10%
2-3%	10-40%
>3%	40-50%

3. Municipal Bonds

Municipal bonds, as everyone knows, are generally not taxable federally and in the state they are issued.

In addition to the tax aspects, municipals differ from other bonds in a number of ways. Key differences are that they are less volatile, and their yields change less with changes in interest rate. Their yield curves have different slopes. The figure below compares AAA National Insured Municipals with Treasuries July 30.



6. Takeaways

- Bonds have risks.
- Short-Term high grade bonds, and particularly foreign. Bonds, achieve the greatest diversification effect.
- Some bonds are inflation protected.
- Different types of bonds respond differently to changes in maturity and changes in interest rates.