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The Market

The stock market is still in a short-term rally despite Dubai. But the very long-term outlook is cloudy. [Kenneth Rogoff](#), Harvard, in [This Time it is Different, 2009](#), studied depressions since 1300 and found that when governments borrow massively abroad in a depression, eventually foreigners will charge higher and higher interest rates. It may take 5-10 years, but it will happen.

In addition to higher interest rates, we will all be hit, not just high earners, by higher taxes, including a [value-added tax](#). In many countries the [VAT](#) is 25%. The increase will not happen immediately, but it will happen.

In the past the US grew out of debt. As the economy grew, tax revenues grew, and the debt could be paid back. Today we do not grow fast enough to achieve this solution.

Currencies: Nov. Japan up 5.2%, Switzerland 1.7%, Euro 1.5%, Mexico 1.2%, China -0.1%, Britain -0.2%, US -3%.

Asset Classes: November, Lrg Growth 6%, Lrg Value 5.7%, Mid Value 5.2%, Mid Growth 4.9%, Sml Growth 3.2%, Sml Value 2.6%, Micro 1.6%.

Sectors: November, Gold Miners up 21%, Metal Mining 15%, Steel 15%, Coal 13%, Silver 13%, Gold 13%, Gbl Mtrl 12%, Agribusiness 12%, Basic Mtrl 12%, Gbl Solar 10%, Transportation 9%, Healthcare 9%, Industrial 8%, Real Estate 8%, Aerospace 7%, Telecommuting 7%, Lumber 7%, Merger-Arbtrtion 7%, Biotech 7%, Software 7%, REIT 7%, Natrl Resources 6%, Cons Gds 6%, Cons Srv 5%, Utilities 4%, Financials 4%, Technology 3%, Energy 3%.

Foreign Investments: November India up 12%, Latin Am 11%, Brazil 11%, Emrg Latin Am 10%, BRIC 10%, Mexico 10%, Emrg Mrkts 9%, Canada 9%, Singapore 8%, Emrg Asia Pacific 8%, Russia 7%, Germany 7%, Asia ex Jpn 7%, Australia 7%, Europe Div 6%, US 6%, Global 100 6%, World 5%, Taiwan 5%, Euro 50 5%, Emrg Mkt Sml Cap Div 5%, Forgn Lrg Div 5%, United Kingdom 5%, China 5%.

Fixed Income: November, Covered Calls 10%, Floating Rate 6%, Utilities 4%, Real Estate Income 3%, Intrntl Treas Bonds 3%, Intl Govt Infl-Protected 3%, TIPS 3%, 10-20 Yr Treas 2%, 7-10 Yr Treas 2%, Interm Bonds 2%, Preferred 2%, Hi Yld 2%, Credit Bonds 2%, Mortgage Backed 1%, 20+ Yr Treas 1%, GNMA 1%, USD Emrg Mrkt 0.8%, Absolute Strategies 0.6%, Emrg Mrkts Gmt down 0.7%.

Fixed Income Investment

1. Introduction

We will be reviewing various [fixed income](#) alternatives. We will show the right and the wrong reasons for investing in fixed income and discuss the risks in detail.

2. Return and Risk

Investing is all about return and risk. Money has value only by what it buys. Hence the return is the purchasing power of your investments. [Risk](#) is the likelihood that you will not generate the cash flow you need nor, in the end, leave an estate with the purchasing power you envisioned.

Investing is about preserving your particular cash flow needs. These needs do not change with the [Consumer Price Index \(CPI\)](#). They change by the amount your particular spending increases. This amount is different for everybody.

If your cash flow needs increase 5% per year, \$1 has purchasing power of only 61¢ in 10 years. Hence, for most of us, investing in asset preserving money market funds is the riskiest investment we can make. [It guarantees](#) that we will run out of money.

3. Types of [Fixed Income Investments](#)

In one article, [Wikipedia lists 43 types](#) of fixed income investments. The most important ones are pensions, social security, annuities, and bonds.

Pensions are a promise of monthly payments guaranteed by the [Pension Benefit Guarantee Corporation \(PBGC\)](#). The guarantee amount is determined annually. The guarantee applies to ["basic benefits"](#) earned before your plan's termination date (or the date your employer's bankruptcy proceeding began, if applicable), which includes most early retirement benefits. They do not include health benefits, nor payments and benefits employees receive when they [leave employment](#). The [maximum monthly guarantee for 2010](#) is a joint and 50% survivor annuity of \$4050 at age 65, of \$1822 at age 55.

[Social Security](#) is not going to go away. Its abolishment is politically impossible.

4. Bonds vs. Bond Funds

Unlike some individuals, all bonds eventually mature. If you buy an individual bond you generally get a fixed amount of interest each quarter and at maturity you get the principal amount of the bond.

RISK	Yield	Maximum Drawdown				12 Mo Total Return
		3 Mo	6 Mo	12 Mo	21 Mo	
PowerShares VRDO Tax-Free Weekly (PVI)						
2	2%	0%	0%	1%	16%	5%
Vanguard GNMA (VFIIX)						
18	4%	2%	2%	2%	5%	8%
S&P 500 Covered Call Fund (BEP)						
114	32%	12%	22%	31%	55%	44%
Vanguard Total Bond Market (BND)						
17	4%	4%	4%	5%	16%	11%
Vanguard Short-Term Bond (BSV)						
11	3%	1%	1%	4%	15%	6%
iShares Barclays 1-3 Year Credit Bond (CSJ)						
14	4%	1%	2%	7%	13%	10%
iShares Barclays Intermediate Credit Bonds (CIU)						
21	5%	2%	4%	7%	18%	19%
iShares S&P National Municipal Bonds (MUB)						
24	4%	5%	5%	7%	18%	12%
Vanguard Intermediate-Term Bonds (BIV)						
30	4%	2%	5%	8%	21%	14%
SPDR Barclays Capital High Yield Bonds (JNK)						
52	12%	8%	10%	25%	45%	55%
iShares Barclays Credit Bonds (CFT)						
31	5%	3%	8%	10%	24%	21%
SPDR Barclays Capital Municipal Bonds (TFI)						
27	4%	5%	5%	8%	25%	12%
PowerShares Insured National Muni Bonds (PZA)						
24	5%	6%	6%	10%	27%	19%
iShares iBoxx \$ Invest Grade Corp Bonds (LQD)						
36	5%	3%	5%	12%	29%	25%
SPDR Barclays Capital S-T Muni Bonds (SHM)						
10	2%	1%	1%	6%	15%	6%
iShares Barclays TIPS Bonds (TIP)						
26	3%	3%	3%	9%	25%	17%
Forward Select Income (KIFYX)						
37	12%	8%	9%	35%	65%	105%
PowerShares Emrg Mkts Sovereign Debt (PCY)						
43	6%	6%	6%	19%	54%	44%
iShares Barclays MBS Bonds (MBB)						
13	3%	2%	2%	11%	11%	7%
iShares Barclays 7-10 Year Treasury (IEF)						
34	4%	3%	4%	13%	13%	2%
iShares JP Morgan USD Emerging Markets Bonds (EMB)						
33	6%	6%	6%	21%	38%	34%
iShares Barclays 10-20 Year Treasury Bond (TLH)						
52	4%	5%	7%	18%	18%	3%
Nuveen Floating Rate Income Fund (JFR)						
66	6%	13%	13%	32%	66%	97%
iShares S&P U.S. Preferred Stock Index (PFF)						
66	9%	13%	13%	57%	69%	43%
iShares Dow Jones US Utilities (IDU)						
76	4%	7%	10%	27%	48%	4%
PowerShares Preferred (PGX)						
56	8%	14%	14%	56%	72%	26%
iShares Barclays 20+ Year Treasury Bonds (TLT)						
65	4%	8%	8%	29%	29%	-6%
PowerShares Financial Preferred (PGF)						
87	9%	13%	15%	66%	77%	44%
Absolute Strategies (ASFIX)						
18	1%	2%	4%	10%	24%	20%
SPDR Barclays Capital Intl Treasury Bond (BWX)						
43	1%	4%	4%	14%	27%	21%
SPDR DB Intl Govt Infl-Protected Bond (WIP)						
48	1%	4%	5%	13%	33%	34%

For small investors it is difficult to diversify. Bonds are expensive to buy and sell in less than millions of dollars except when issued. On the other hand, [open and closed end](#) bond funds, as well as [exchange traded bond funds \(ETFs\)](#), have no maturity and no fixed interest rate, but are easy to buy and sell at any time.

5. Sample Fixed Income Portfolio

Below is an example of a fixed income portfolio:

S&P 500 Covered Calls	1%
Vanguard GNMA	10%
iShares Barclays Intermediate Credit Bonds	9%
Power Shares Insured National Muni Bonds	9%
Forward Select Income	1%
SPDR Barclays Capital High Yield Bonds	16%
Power Shares Emerging Markets Sovereign Debt	6%
iShares JP Morgan USD Emerging Markets Bonds	5%
SPDR Barclays Capital International Treasury Bonds	5%
iShares Barclays TIPS Bonds	10%
SPDR International Govt Inflation-Protected Bonds	28%

6. Maximum Drawdown

The table on the left shows the [RiskGrade](#) (RISK), 1 Year Yield (Yield), [Maximum Drawdown](#) (decrease in total return from previous high) for 3, 6, 12 and 21 months (data for some ETFs were available only for 21 months), and 12 Month Total Return. Total return includes price changes and interest. The last 12 months were very unusual and cannot be used to forecast future returns. The future will see a "New Normal".

The table shows that some of the bond funds have drawdowns higher than some stocks. [Covered Calls \(BEP\)](#) had a 1 year yield of 32% and a 21 month drawdown of 55%. [Preferred Shares \(PFF\)](#) had a yield of 9% and drawdown of 69%. [Hi Yield Bonds \(JNK\)](#) had a yield of 12% and a 45% 21 month drawdown.

7. Bottom Line

- Investing is about [purchasing power preservation](#), not asset preservation.
- These are very unusual times. The "New Normal" will be different.
- The fixed income part of your portfolio should contain [inflation protected securities](#), emerging market debt and foreign currency debt to protect against inflation and a falling dollar.

I would be glad to discuss your own investments with you.

If you have questions write to curtfey@cutfey.com.