

Lowly Analyst Newsletter

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The Economy and the Markets Low Risk Investing

The Economy and the Markets

Nothing has fundamentally changed in the economy and the markets in the last few weeks except psychology. If you have a well diversified portfolio at an acceptable risk level, you do not have to worry. The current abnormal low volatility increased. This increase may require portfolio adjustments to lower risk. Fundamentals and psychology compete. Don't know what will win.

The effect on world markets of the drop in Thailand's Bath and the China drop in Feb. show the growing influence of the developing markets.

The US economy is losing steam. Our GDP growth rate in 4Q '06 was a paltry 2.2%; inflation was 2.7%. Our consumer spending weakened. This performance does not seem to have affected the rest of the world. GDP growth is as follows: China 10.5%, India 8.3%, Argentina 7.9%, Russia 6.7%, Spain 4.8%, Japan 4.8%, Euro Area 3.6%.

Of course the real test will come next year when the economies slow down and the effect of falling home prices will have fully influenced US consumer spending.

Asset Classes: For 6 months mid value up 12%, small growth 11%, mid growth 11%, small value 10%, micro 10%, large value 8%, large growth 7%.

Sectors: For the 6 months, Basic Matr. up 21%, Utilities 18%, Aerospace 16%, Oil Eqp. & Srv. 14%, Real Estate 13%, Natrl. Rsrc. 13%, Telecom 13%, Energy 13%, Commodities 13%, Medical Dvcs. 12%, Gold 11%, Industrials 9%, Cons. Srv. 9%, Transportat. 8%, Hlth. Care Provider 7%, Tech 5%.

Foreign Investing: For the past 6 months Poland up 33%, Malaysia 31%, Brazil 31%, Columbia 30%, Sweden 29%, Singapore 28%, China 28%, BRIC 28%, Mexico 27%, Argentina 27%, Pacific Rim 27%, Chile 26%, Latin Am 26%, Russia 25%, Austria 24%, Turkey 22%, Czech Rep. 21%, SAfrica 21%, Australia 21%, Denmark 21%, Hungary 18%, Israel 17, Spain 17%, EmergingMrkts. 17%, DevelopedMkts. 14%, Europe 13%, Hong Kong 11%, Japan 9%, India 8%, World 6%, Canada 5%.

Low Risk Investing

1. Introduction

In order to achieve the desired cash flow investors hold high return, high risk securities. To keep portfolios at an acceptable risk level one must balance the high risk assets with low risk ones.

Low risk assets include social security, pensions, annuities, preferred stocks, convertible stocks, bonds, writing calls, arbitrage. Most importantly low risk investing is more than just investing in bonds. Low risk investing is not no risk. Some bonds are very risky. Investments vary in amounts of risks.

2. Risk and Returns

Returns generally increase with risk both for bonds and for stocks. Nothing is wrong with taking risks provided the compensation is adequate. For bonds the risk increases with maturity or more accurately with the duration. Duration is the average maturity of the cash flows, the bond maturity adjusted for dividends.

Thus a bond with a five year duration is riskier than a bond with a one year duration.

3. Bond Prices and Interest Rates

As interest rates fall, bond prices rise and vice versa. A one-year bond \$1000 that earns 5% is worth \$950 today. The \$950 plus the \$50 in interest makes it worth \$1000 at maturity; if interest rates are 10%, that bond is worth \$900 today so that after the \$100 interest it is also worth \$1000 at maturity. If the interest rate falls from 10% to 5% the bond price increases from \$900 to \$950. Falling interest rates increase bond prices. If interest rates increase from 5% to 10% the bond falls from \$950 to \$900

4. Future Interest Rates

Future Interest rates cannot be predicted. However, the best way to estimate future interest rates (with high error rates) is to use today's yield curve. If today a money market account earns 5.22% and a 5 yr. treasury note earns 4.46%, the best forecast is that in the future the money market will earn 4.46%. Under these circumstances it is better to hold the money market account.

5. Notation RTRN=1 yr Return, Volat=volatility, Sharp=Return/Risk, Common variance=correlation with US stock market (lower better), Bear=bear market decile (lower better), E/R=expense ratio.

6. Ultra Short Term Bonds

Harbor Short Duration, HASDX

	RTRN	Volat	Sharp	RiskGrade
Fund	5.3%	1.7%	.19	4%
Common Variance	80%	Bear 1	E/R	0.39%

Schwab Yield Plus Investor, SWYPX

	RTRN	Volat	Sharp	RiskGrade
Fund	5.2%	1.8%	0.12	3%
Common Variance	83%	Bear 1	E/R	0.58%

AMF Ultra Short Mortgage, ASARX

	RTRN	Volat	Sharp	RiskGrade
Fund	5.0%	1.7%	-.01	4%
Common Variance	82%	Bear 1	E/R	0.46%

7. High Yield Bonds

Northeast Investors, NTHEX

	RTRN	Volat	Sharp	RiskGrade
Fund	12.4%	3.7%	1.98	15%
Common Variance	83%	Bear 1	E/R	0.80%

Excelsior High Yield, EXHYX

	RTRN	Volat	Sharp	RiskGrade
Fund	4.9%	4.9%	1.62	4%
Common Variance	29%	Bear NA	E/R	3.02%

Pioneer High Yield, PYICX

	RTRN	Volat	Sharp	RiskGrade
Fund	4.2%	4.2%	1.35	24%
Common Variance	95%	Bear 1	E/R	1.81%

PIMCO Floating Income, PFIDX

	RTRN	Volat	Sharp	RiskGrade
Fund	7.4%	2.7%	0.91	10%
Common Variance	20%	Bear 1	E/R	0.95%

8. Short Term Bonds

Vanguard Short-Term Investment-Grade, VFSIX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.1%	2.1%	0.52	8%
Common Variance	84%	Bear 2	E/R	0.07%

Vanguard Short-Term Investment-Grade VFSTX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.0%	2.0%	0.48	23%
Common Variance	84%	Bear 2	E/R	21%

Vanguard Short-Term Investment-Grade, MWLDX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.0%	2.2%	0.47	15%
Common Variance	90%	Bear 2	E/R	0.58%

9. Intermediate Term Bonds

Westcore Plus Bond, WTIBX

	RTRN	Volat	Sharp	RiskGrade
Fund	7.8%	2.9%	0.97	12%
Common Variance	90%	Bear 2	E/R	0.58%

American Funds Bond Fund of Amer, BFAFX

	RTRN	Volat	Sharp	RiskGrade
Fund	7.4%	2.7%	0.87	10%
Common Variance	85%	Bear 4	E/R	0.60%

Dodge & Cox Income, DODIX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.9%	2.6%	0.74	10%
Common Variance	88%	Bear 4	E/R	44%

10. Inflation Protected Bonds

DWS GNMA'S, SGINX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.3%	2.5%	0.53	11%
Common Variance	85%	Bear 3	E/R	0.59%

11. Bank Loans

Highland Floating Rate, XLSBX

	RTRN	Volat	Sharp	RiskGrade
Fund	8.6%	2.9%	1.27	
Common Variance	84%	Bear 1	E/R	1.56%

Eaton Vance Floating-Rate & Hi Inc Adv, EAFHX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.4%	2.3%	0.64	4%
Common Variance	88%	Bear 1	E/R	1.05%

Morgan Stanley Prime Income Trust, XPITX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.1%	2.1%	0.52	NA
Common Variance	87%	Bear 1	E/R	1.25%

12. Arbitrage

Merger, MERFX

	RTRN	Volat	Sharp	RiskGrade
Fund	9.2%	3.0%	1.41	13%
Common Variance	79%	Bear 1	E/R	1.37%

13. Mortgage Based Securities

Federated Income, FICMX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.6%	2.6%	0.64	NA
Common Variance	85%	Bear 3	E/R	59%

Fidelity Ginnie Mae, FGMNX

	RTRN	Volat	Sharp	RiskGrade
Fund	6.0%	0.41%	0.41	11%
Common Variance	84%	Bear 3	E/R	0.45%

American Century Ginnie Mae, BGNMX

	RTRN	Volat	Sharp	RiskGrade
Fund	5.8%	2.3%	0.33	12%
Common Variance	85%	Bear 3	E/R	1.57%

14. Emerging Market Bonds

Payden Emerging Markets Bond, PYEMX

	RTRN	Volat	Sharp	RiskGrade
Fund	9.1%	4.2%	0.96	23%
Common Variance	90%	Bear 4	E/R	0.80%