

ASPERA UPDATE

Intelligent, Independent Investment Management

The What And The Why Part 2: Yield

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Aspera offers independent fee-only investment management and advisory services throughout the Triangle area and nationwide.

Every client portfolio is separately managed.

The securities and strategies discussed in this Update may not apply to every client portfolio.

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“The enemy of the conventional wisdom is not ideas but the march of events.”

John Kenneth Galbraith

No one can accuse me of making my life easy for myself. Our largest risk position (precious metals) is understood by few in the investment industry and widely dismissed, even after a 10-year bull market in gold. To further complicate matters, you’ve often heard me say that some of our equity positions should really be viewed as bond positions. If my investments and commentary weren’t raising questions and eyebrows, I wouldn’t be doing my job. Such is the life of a value-focused contrarian.

This “What and Why” series really has two purposes. The first is to explain why we own what we do in our portfolios. The second is to quell any concerns regarding my sanity. The former is fairly straightforward. The latter is more challenging. My approach is quite different from what the investment industry preaches and practices, and much of what I say and do is very different from what you’ll hear from other advisers, CNBC, and most other air suckers. Part of my job is helping those of you with less investment expertise unlearn the brainwashing propaganda you’ve long been subjected to. This series and much of what I write can be thought of as an investment intervention.

In Part 2 of this intervention series, we’ll be tackling the “yield” portion of our portfolios. This will be more relevant for our more conservative clients as the “yield” portion of their portfolio will be more significant. Nevertheless, it’s an important review for all of us. I get a number of questions about bonds and yield, so hopefully this discussion will answer any questions you’ve already asked, any questions you’ve had but haven’t asked, and questions you didn’t even know you had.

The Traditional Approach To Yield: Bonds

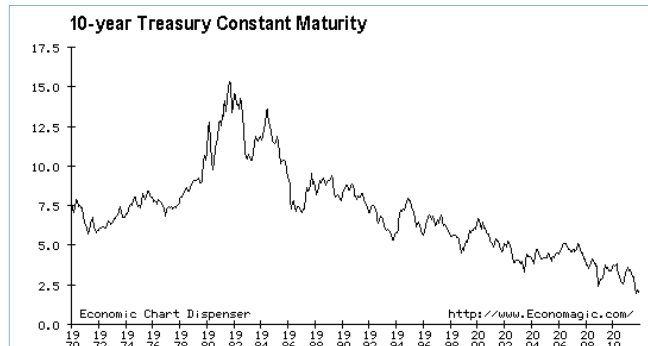
It should come as no surprise that my approach to yield differs a bit from the conventional view. To understand the non-traditional, it helps to understand the traditional.

When most people think of yield, they immediately think of fixed income securities (bonds). This is particularly true of retirees and those nearing retirement. **Investors have been conditioned to believe that**

they need to shift more of their portfolio into fixed income securities as they age and become more risk averse. The financial industry has long preached that bonds are a safe and wise investment for conservative investors. Why? It sells, and it has worked wonderfully for the last 30 years!

The chart below tells an amazing story. It shows the yield (interest rate) on a 10-year Treasury bond, and it succinctly describes a 30-year bull market in high quality bonds. Yields peaked at just over 15% back in the very early 1980s and have trended lower ever since. There have been occasional years when bond prices have dropped, but they've proven temporary. Today, in the last gasps of the bond bull market, you can give the U.S. government your money for 10 years, and in return, they'll promise to pay you the kingly rate of 2% for each of the next 10 years.

Figure 1: 10-Year Historical Treasury Yield



Importantly, inflation has also trended lower over this 30-year period, resulting in these safe bonds generating a solid real return. [Note: “real” means the return after subtracting inflation. If your bond yields 5% and inflation is 3%, you earn a real return of 2%.] **At any point over the past 30 years, an investment in a Treasury bond has been extremely safe and has generated a return in excess of the rate of inflation – perfect for conservative investors.**

When a market has moved in one direction for so long and consistently generated a safe real return, it becomes difficult for many to imagine anything different. **This is one of the common errors investors make – extrapolating the past indefinitely into the future.**

Basic Bond Fundamentals

Let's back up for a moment and look at what a bond represents. A typical bond represents a promise from the issuer to pay a specified rate of interest over some specified period. If you put \$1,000 into a Treasury bond which pays 3% and matures in 5 years, you'll receive \$30 each year (typically \$15 every six months) and then get your \$1,000 back at the end of 5 years.

Now let's look at a few important concepts:

1. With bonds, it's important to understand that **interest rates and prices move inversely**. When interest rates rise, the price of existing bonds will fall. To help understand this, imagine that you bought the new 5-year Treasury bond mentioned above. You pay \$1,000 (par) for the bond which will pay an interest rate of 3%. Now imagine that interest rates spike higher (the reason isn't important) by one percentage point the day after your purchase, and the Treasury issues a new 5-year bond that very next day. The brand new bond will cost \$1,000 and have an interest rate of 4% while your bond will still have a rate of 3%. Why would anyone now pay \$1,000 for your bond if they could pay the same amount and earn a higher interest rate on the new bond? Of course, no one would. The price of your bond would have to fall in order to entice buyers.

Remember, these bonds will be redeemed by the government at full face value at maturity (\$1,000 in our example). An investor who pays less than \$1,000 for your bond will earn the 3% interest rate (coupon) on the bond but also receive some extra return in the form of price appreciation as the value of the bond moves back toward its \$1,000 value at maturity. **The price of the 3% bond will fall by an amount which will equalize the total expected return of the two bonds. Conversely, when interest rates fall bond prices will rise.**

2. The magnitude of the price rise or fall relative to a change in interest rates depends on a number of factors, chiefly the amount of time until the bond matures. **Longer-dated bonds will experience sharper price moves for any interest rate change than shorter-dated bonds.** This means that

there is more interest rate risk for longer-term bonds than shorter-term securities. Shorter-term securities will mature sooner, so your principal can be reinvested in new higher-yielding bonds more quickly. Therefore, you'd rather own shorter-term bonds if you expect rates to rise and longer-term bonds if you expect rates to fall for an extended period.

3. Other types of bonds tend to trade based on a yield spread to Treasuries. **Treasury bonds are used as the benchmark for most fixed income securities.** Historically, this has been the case because Treasury bonds have been deemed risk-free. If a 10-year BBB-rated corporate bond has a yield of 6% and the 10-year Treasury has a yield of 2%, the spread would be 4%, or 400 basis points (100 basis points equals 1 percent). These spreads will widen and narrow over time.

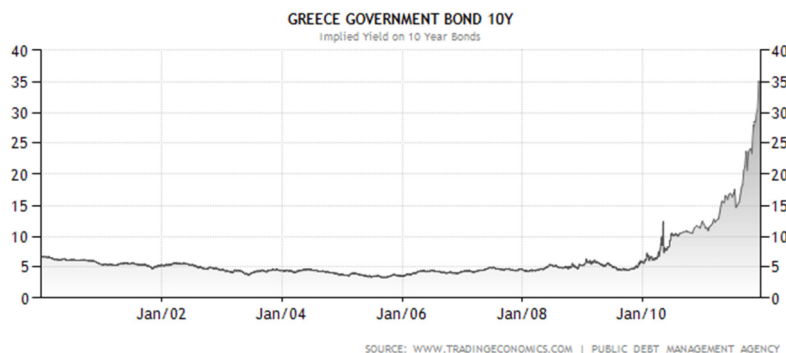
Bond Fundamentals: Risks

Now that we've covered some basic bond mechanics, let's look at some of the key risks we face when investing in bonds.

1. **Default Risk (also Credit Risk):** The financial strength and stability of the bond issuer is critically important. If you lend your money to (buy a bond from) a company that goes out of business before your bond matures, you could easily lose 50-100% of the money you invested. This is why bonds issued by a small unprofitable telecom firm will offer a higher yield than IBM, Proctor and Gamble, or McDonalds. **Issuers with higher default risk must offer higher interest rates on their bonds to compensate for their increased risk and attract buyers.**

Default risk also applies to countries. I can assure you that investors who were buying Greek government bonds a few years ago thought they were buying essentially riskless government bonds. Figure 2 shows how the yield on Greek 10-year bonds has spiked over the last couple of years. Remember, price moves inversely to yield, so the price of these bonds has plummeted. These "riskless" bonds have proven extremely risky. Buyers of Italian, Portuguese, Irish, and Spanish bonds have also experienced significant losses in recent years.

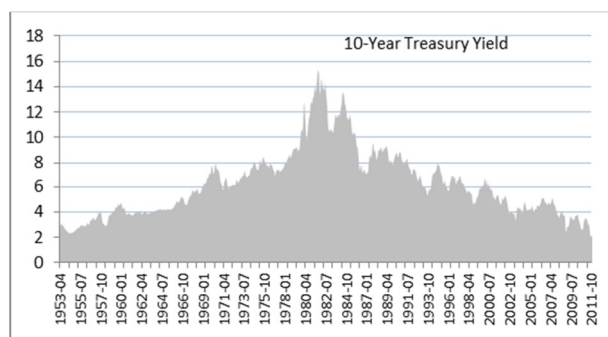
Figure 2: 10-Year Historical Greek Government Bond Yield



2. **Inflation (Purchasing Power) Risk:** **Traditional bonds lock you into an interest rate** for some period of time. If you buy a 10-year Treasury today, you'll get a 2% return for the next 10 years. But what if inflation accelerates to a 5% rate? In that case, the purchasing power of your money will fall every year. In such a world, \$1,000 invested at 2% will grow to just over \$1,200 in 10 years, but a basket of goods and services that costs \$1,000 today will cost a little over \$1,600 10 years from now. **Your money won't go nearly as far in the future if your return doesn't keep up with the rate of inflation.**

3. **Interest Rate Risk:** I discussed this earlier. This is the risk that interest rates will rise, thereby decreasing the price/value of your bond. This risk is greater for longer-term bonds than shorter-term securities.

Figure 3: Historical 10-Year Treasury Yield (1953-Present)



I've emphasized the fact that high-quality bonds are now 30 years into a bull market. Let's look a little further back now. Figure 3 shows the 30 year span prior to the start of this bull market, and we see a much different picture. Interest rates climbed steadily for 30 years, culminating in the inflation-induced ramp from 7% to 15% from the late 1970s to the early 1980s. The past 60 years have seen a 30-year bond bear market followed by a 30-year bond bull market.

The Outlook For Rates

Currently, yields are at very low levels. This doesn't mean they won't fall further in the months and years ahead, but the long-term chart (above) of yields should give pause to those looking to invest in longer-term bonds. Locking in these low yields makes perfect sense if you're a borrower, but savers should think twice.

Why might Treasury yields fall further in the near term? For one, **Treasury securities have been benefiting from a flight to safety.** Investors aren't necessarily buying Treasuries because they're attractive on an absolute basis. They just look better than other "safe" alternatives at the moment. If you want to appear more attractive, just stand next to someone less attractive (a key reason my wife married me). Treasuries look pretty safe right now relative to the bonds of many European countries.

Treasury yields also tend to follow the path of economic growth over the intermediate-term. Lower growth usually means lower inflation, and lower growth results in a higher savings level relative to investment opportunities. Both serve to push interest rates down. As you know, I do expect a weak to declining economy moving forward, so this could support bond prices in the near-term and keep rates low.

On the other hand, we have a massive debt burden (government and private) and an annual federal budget deficit or roughly \$1.5 trillion. We have a government which has shown zero ability or real desire to tackle the issue of defense and entitlement spending. A debt burden can't grow indefinitely. At some point, the bond market revolts and demands higher interest rates for the increased risk of default. Just look at what has happened to Greece, Ireland, Portugal, Italy, and Spain.

There is, however, one key difference between these European countries and others such as the U.S. and Japan (which has even lower interest rates). **The U.S. and Japan have a printing press, and they're not afraid to use it.** While the risk to investors in southern European government bonds is one of actual default, the risk to buyers of U.S. and Japanese government debt is one of inflation/debasement. Too much of their debt is held by their own citizens. **Instead of defaulting, they will resort to the more politically palatable option of creating more money out of thin air (this is a key reason we own precious metals).** This is a slick and subtle form of default since debts will be paid back with a cheapened currency.

So, the risk to longer-term bonds currently is that you will be locking in record low yields as the purchasing power of your money may be about to decline more significantly. 10-year treasury yields are below 2%. Do you really want to lend this government your money for the next 10 years in exchange for a paltry 2% per year given our massive debt and deficit and the central bank's bias toward inflation? Perhaps it will work out, but it strikes me as a sucker bet. It may be fine for a short-term trader who is betting on yields to fall further in the months ahead, but I don't know why anyone would want to buy and hold such a security. Given a choice between cash and long-term Treasury bonds, I'd happily take my 0%-yielding cash, remain liquid, and wait for a better investment opportunity. And remember that other bonds

are priced off of Treasuries, so when Treasury prices eventually do start falling, the prices of other types of bonds (corporates, municipal bonds, mortgage bonds, etc.) will follow.

The Aspera Approach To Yield

My view of yield is fairly simple:

1. Focusing on yield alone can be hazardous to your financial health. **Securities with a yield (some type of distribution) can be overvalued or undervalued, attractive or unattractive.** In this sense, they're no different than any other security. Knowing only the yield of a security tells us very little.
2. The theory that we should move more of our money into bonds as we age is incomplete. If bonds are attractively valued and safe, then this course could make perfect sense for some, but **ignoring valuation, risk, the economic outlook, and your specific financial and personal situation makes zero sense. Picking securities based just on your age is another ridiculous financial industry construct. It's a lazy rule of thumb for advisers who don't understand risk or know how to evaluate a security.**
3. I have nothing against bonds in general. We own some. I also have nothing against the idea of retired/conservative investors owning a portfolio which will generate safe income that they can live off of without depleting their portfolio too quickly. The concept is perfectly valid. The problem today is that this doesn't work for many people. **Currently, safe yields are too low to generate enough income and preserve portfolios for many retirees. We can thank Bernanke for that.**
4. I have no interest in chasing yield. **Stretching for higher yield without concern for the risks being incurred is dangerous and the antithesis of effective portfolio management.**
5. **There are many different types of securities beyond traditional bonds which provide some type of yield. At any given time, some will be more attractive than others.**
6. **Rather than focusing on yield, it is much more important to focus on the total return of your portfolio.** This incorporates distributions from yield securities but also price appreciation from others. If yield securities are overvalued, we'll own fewer of them. If they're attractive, we'll own relatively more, particularly in conservative accounts.

To better understand this, think about making a withdrawal from your portfolio to help pay for your living expenses. Does it really make a difference whether the money you're withdrawing came from income or capital gains? In a taxable account, you may even find a tax advantage to long-term capital gains versus income.

Our concern is whether our portfolios will last us through retirement. My job is to help ensure that they do by generating an appropriate, long-term, risk-adjusted return. That is all that matters. Whether we achieve that through owning securities with a yield or other non-yielding securities is not important.

Our Current "Yield"

Hopefully, I've made it clear that I'm not currently a big fan of traditional long-term bonds. Fortunately, we're not limited to this space in our search for yield. We have been able to put some money to work in various yield plays over the last few years. We currently have yield exposure in the following areas:

1. Short-Term Bonds: We own some individual bonds as well as the Vanguard Short-Term Bond ETF (BSV) in a number of accounts. **This is exposure to high-quality, shorter-term bonds.**

We are taking very little default or interest rate risk with these securities. The trade-off, of course, is that the yield on these positions is quite modest.

2. Treasury Inflation-Protected Bonds (TIPs): These are Treasury bonds but with a twist. **The principal value of these bonds will increase with inflation.** The yield on these bonds is modest, but we at least get some degree of inflation protection. One unique risk to these bonds is that the principal adjustment is based on the government-issued Consumer Price Index (CPI). I am in the camp which believes that this number does not accurately reflect our real-world inflation, so TIPs may not provide full inflation protection.
3. Dividend-Yielding Stocks: Although most investors immediately think of bonds when they think of yield, many stocks pay dividends. **We own a number of dividend-paying equities which I view more as bonds than stocks (more on this in the next section). One key component of many of the dividend-paying equities we own is that they operate in businesses which would tend to benefit from future inflation (primarily energy).** Royal Dutch Shell is a terrific example. They are a huge energy company which benefits from rising oil prices. As oil prices rise, they generate more cash and are therefore able to increase their dividend. The yield on their equity is about 5%. We get a nice yield with some inflation protection coming from a company which isn't likely to disappear any time soon. I view this more as a perpetual inflation-protected bond than an equity.
4. Limited Partnerships: We've owned some limited partnership positions for a few years now. These are **primarily in the natural gas distribution business. Like Royal Dutch, they've provided a nice yield and a rising dividend.**
5. Emerging Market Local Currency Bonds: We own a modest position in an ETF which owns bonds from various emerging market countries. Importantly, **these bonds pay interest in the currency of each host country, rather than in dollars.** This means that we are taking some currency risk with this security. Emerging market bonds could come under pressure in the near term if global growth slows and the dollar rallies. I would expect to boost this exposure should this unfold. Many of the countries that this fund invests in have a much better debt and deficit picture than the U.S., and I expect their currencies to outperform over the coming decade. It provides a mid-single digit yield with a potential boost from currency appreciation.
6. Real Estate Investment Trusts (REIT): Currently, we only own one REIT, and it's a mortgage REIT. Annally Capital Management borrows money and invests in mortgage-related securities. They currently provide a 14% yield, which is certainly high. The company does a good job of managing risk, but you don't get a 14% yield without some risk. The company relies on leverage (debt) to magnify the yield spread between the funds they borrow and the securities they invest in. That's how you turn a modest spread into 14%.

Non-Bonds As Bonds

We (and that includes you) are not looking to profit from trading bonds. We look to them for stable income. If you buy a 10-year bond from Exxon, you probably aren't hoping to sell it at a higher price in a month or a year. You bought it for the yield (income) it will provide, and you intend to own it for the entire 10 years.

The price of this bond, however, will change from day to day. It won't be as volatile as a biotech stock, but the price will definitely vary from day to day. Do you care about these price changes? Do you wake up one morning concerned that the price of your bond fell a little bit? Do you wake up other mornings thrilled that the price of the bond rose? Hopefully, these are rhetorical questions. **If you have no plan to sell the bond prior to maturity, why would you care about daily, monthly, or annual price changes? So long as you receive your interest check, you're happy.**

This is precisely how I approach the yield securities in our portfolio, whether they are bonds, stocks, REITs, or limited partnerships. Of course, our distribution-paying equities, REITs, and limited partnerships are more volatile than high quality bonds, but why would that concern us? The price volatility has no impact on the company's ability to pay and grow its distributions. The price changes are simply a distraction that you'd be better off ignoring. Our yield positions are not

purchased for their capital appreciation. They are bought because they offer an attractive risk-adjusted yield and/or some built-in inflation protection.

Non-Bonds As Bonds - An Example

Let's take an example right out of our conservative portfolios. The chart below is of Enterprise Products Partners (EPD). This is a limited partnership holding in some of our conservative accounts. We bought this security in March and April of 2009 at prices between \$18 and \$22.50. At that time, the trailing 12-month distribution was \$2.08 per share, which worked out to a 10% yield (\$2.08 distribution divided by the \$20 share price). Currently, the trailing distribution is \$2.41, so the distribution has grown 16% since the time of our purchase. **Those \$20 shares we bought are now generating an annual distribution of \$2.41, which works out to a 12% yield.** This is what I like -- a stable company that is generating a solid yield which is likely to grow over time and offer some protection from inflation. [Note that an investor buying EPD today would be receiving a yield of only 5.2% (\$2.41 divided by the current price of \$46).]

Figure 4: EPD Shares (2008-Present)



Importantly, notice the volatility of the security in the chart. EPD fell from \$34 to \$17 in 2008 and has since climbed to \$46. Your first thought might be "Wow. What a great call. Look at that price appreciation! I'm going to send Ken a box of chocolates!" The reality is that I bought this security for its nice and relatively secure yield (10% when purchased), not for price appreciation. **The price**

appreciation does not excite me. We could sell this security today, but we'd be left with 0% cash instead of the 12% yield we're currently enjoying. Just as this price gain doesn't excite me, a decline in the price would not concern me, so long as the distribution-paying capacity of the company remains robust. To me, this is simply a perpetual, inflation-protected bond. But yes, you should still send a box of chocolates.

Impact On Performance Evaluation

What does this mean for performance evaluation? It means that you have to be careful when looking at portfolio returns. Our "yield" securities will vary in price, and this will impact the value of your portfolio quarter to quarter. Realistically, however, you would be better served to segregate these names and ignore changes in their value. Any decrease in the value of your portfolio due to price declines in these names is irrelevant to me, but this will occur when the market pulls back. My only concern at these times is the distribution-paying capacity of the issuer. In fairness, portfolio appreciation due to these names is best ignored as well. Again, unless these prices climb well above fair value, we're unlikely to sell after a rise. Again, I view these positions much more like bond securities than equities. You should, too.

Conclusion

1. Yield comes in many forms. Don't fixate on traditional bonds.
2. Various yield securities are valued attractively at different times. There are no absolutes.
3. Fixed-income investing involves various types of risk. Ignore these at your own peril.
4. Our yield securities currently serve one of two purposes:
 - a. Safety with a low yield -- essentially a cash substitute
 - b. Attractive yield and/or protection from future inflation

Yield is a sticking point for many investors due to years of brainwashing. Parking money in "safe" longer-term bonds to earn a little extra income until better opportunities come along could prove treacherous in the decade ahead. **No one will ring a bell when interest rates bottom and start their next long-term bear market, but price declines in longer-term bonds will swamp the modest income they provide when this day comes.** If you want or need to sell these securities at such a time, you may incur a significant loss. If you just hold on to maturity, your return will fall short of inflation, and the purchasing power of your money will decline. There is a time for conservative investors to plow a lot of money into long-term bonds and forget about it. This is not that time.

Fortunately, there are many ways to invest in yield, and at any given time, some are bound to be attractive. We own a number of these positions, but there are few new compelling opportunities at the moment. **As with all of our positions, we'll add to this space (particularly for conservative accounts) only when we believe we are getting adequately compensated for the risk we're taking.** In the meantime, we'll continue to park some funds in cash and cash substitutes and be patient.

Speaking of cash, Part 3 of this series will deal with that very topic. Cash is another sticking point with many investors. If the market is rising, investors are upset if they're not fully invested. If the market is falling, they're upset that more of their portfolio isn't in cash. How can something so innocent cause such conflict?! At the risk of spoiling the punch line of Part 3...CASH IS NEVER A BAD THING. I may have said that once or twice before. I'll be saying it a few more times in the next installment.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

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