

Don't Stretch For Yield

I was at a long time friend's home this weekend and mentioned that I needed to write my quarterly newsletter. In a sarcastic tone he said, "Let me guess, you are going to write something about earnings". As I thought about it, I realized he was right. Over the last fifteen years, I have written about earnings one way or another in most of our newsletters.

With earnings being an important part of valuing the market or a company, it makes sense that earnings are mentioned often in our newsletter. Focusing on earnings is a way to take emotion out of investing and keep us focused. Today the S&P 500 is trading for 12 times next year's earnings. Other than the past 2 years, it has not been this low since the early 90's. With the companies in the S&P projected to grow at over 20%, the market is a good value on a historical basis. Emotion has caused the market to pull back over 13% this quarter leaving it down around 9% for the year. If we let emotion control our decision making process we would be selling companies at the wrong time.

The recent pull back in the market is healthy. After going up 46% the last 12 months, it needs to regroup before it can move forward. Once we get through the summer and the next earnings reports, we should see emotion turn and the market start moving upward again.

Enough about earnings. Let's talk interest rates. The Federal Reserve is continuing to hold interest rates artificially low to help stimulate the economy. These low interest rates are great for banks, the housing industry and any company that can refinance their debt at a lower level. However, low rates are not beneficial for fixed income and money market investors.

Money market rates are close to zero and short term bonds are not much better. If you go out further on the yield curve and purchase a 10 year government bond you would only receive 3%. At 3%, a 10 year

government bond yields less than the rate of inflation. On an inflation adjusted basis, you would have a negative return on your safe money.

These low yields have investors looking for someplace else to invest their safe money. There are many ways to increase the yield in your portfolio. One is buying longer term maturities. The other is to purchase individual corporate issues such as bonds, preferred stock and/or funds that invest in them. If you invested in any of these, you would be adding risk to your portfolio.

In a rising interest rate market you will see the value of all these investments go down. It is true that if you hold a bond to maturity you will receive all of your investment back, but you are locked into a low return until it matures. Unlike longer term bonds, mutual funds never mature. If rates go up far enough your investment return will be negative.

Corporate issues also add credit risk to your portfolio. The value of the issues will move up and down as the credit quality of the issuer changes. If the company has financial problems or gets bought out, the value of your investment will go down and could become worthless.

We would not suggest these types of investments to our clients for their safe money. We feel that if you want to add more risk to a portfolio, it would be better to increase your equity allocation. With corporate bonds your return is limited but you risk losing the entire principal. With equities you have the same downside but unlimited upside potential.

We are suggesting clients look at using their bond money to pay off their home loan. Otherwise, for our balanced accounts we are keeping the bonds short term so we can take advantage of when the Federal Reserve stops holding rates artificially low and yields increase.

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