

Key Points

- ◆ Next major move in rates likely to be much higher
- ◆ Bond Bear Markets can last decades
- ◆ Income investors need to beware of their income choices

Income Investors Beware

John Riley
Chief Strategist

With interest rates having come down to their lowest levels in decades, income investors are scrambling to find yield. But they need to be careful where they look. Income investments can be just as dangerous as stocks, and much less forgiving. The reason is simple - interest rate cycles.

Below is a long term chart of the 10 year Treasury yield. It shows very clear long term cycles. Multi-decade bear markets followed by multi-decade bulls.

Interest rates and bond prices have an inverse relationship. As one rises, the other declines. (This applies to pricing of bonds on the secondary market. If held to maturity, most bonds mature at face value.) Here's how it works:

A hypothetical example of this would be if you were to buy a bond for \$10,000 due in 20 years. It has a 5% coupon rate. But a couple of years later, rates climb to 7%. Wanting the higher rate, you plan to sell your bond and buy the higher rate bonds. But you can't. Your bond is no longer worth \$10,000. It is worth about \$8,100 on the secondary market.

The Downtrend May Be Over



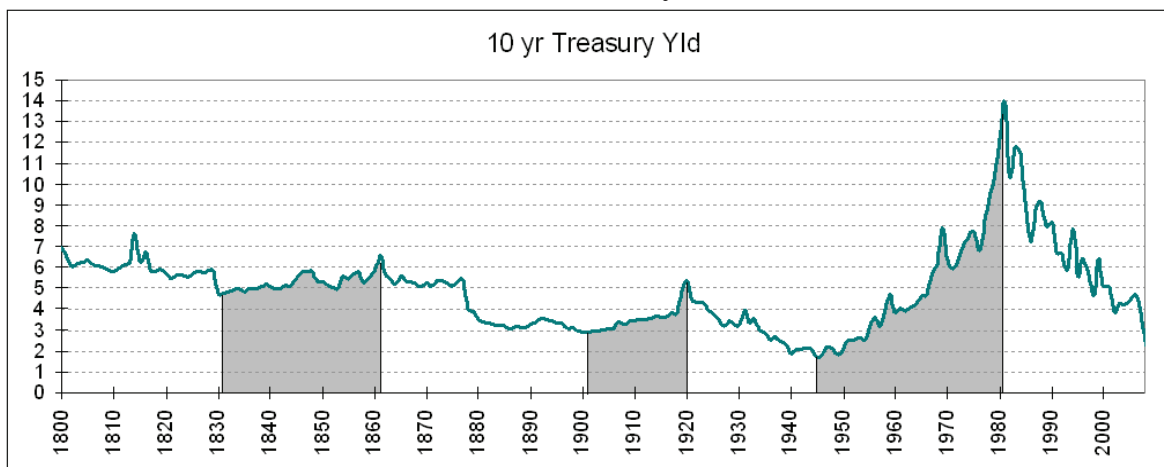
Above is a chart of the 30yr Treasury yield. After peaking at about 14.50% in 1982, long term interest rates have been declining for 27 years. They declined below 3% recently. With rates this low, investors have few good choices for income. The next major move is higher.

This is because of Yield to Maturity (YTM).

Current interest rates force all other bond sectors into a relative equilibrium between price and current yield. (Equilibrium is based on ratings, duration, etc, described later in this report) If rates have gone up, bond prices come down. If rates go down, bond prices rise.

This is because of the way the market works. Why would anyone pay full price for a bond yielding 5%

Interest Rate Cycles



Source: Federal Reserve; Format: CIS

Bonds can have bull and bear markets. You can see the cycles in the yield of the 10 yr Treasury. The grey areas are times of rising rates, and because of the inverse relationship with bond prices, this creates a bear market for bonds. Conversely, bull markets in bonds are when rates are declining, this is the white areas. The bulls and bears have been measured in decades in the past.

With everything we know about what the Federal Reserve has done to the money supply, the trillions in bail-outs and the trillions in additional debt offerings, our research indicates that the next bear market in bonds could be especially bad.



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Key Points

- ◆ Interest Rates are the primary factor in market prices of bonds
- ◆ Shorten maturities when rates are rising
- ◆ Preferred Stocks get a double whammy of declining prices and potential dividend cuts when rates are rising

when current new bonds yield 7%? So in order to entice buyers, sellers have to drop the price for the bond until it hits an equilibrium price, the YTM. Conversely, if a seller has a bond yielding 7% when the prevailing rate for similar bonds is 5%, he can demand a premium, or higher price for his bond.

Factors Effecting Prices

Several factors contribute to the pricing of bonds on the secondary market.

Duration – This is the term of the bond. The longer the term is, the higher the volatility on the secondary market. As interest rates rise, a bond with a 30 year maturity will likely drop more than a similar bond with a 10 year maturity.

Strategies are simple - as interest rates are rising, investors want to shorten maturities. As rates are dropping, investors want to extend maturities.

Ratings – This relates to the quality of the bond which will determine the interest the issuer will have to pay. Bonds get ratings anywhere from AAA down to D. Anything above BBB is investment grade, below is junk. The US Federal Government has the highest rating of any entity in the world.

Ratings relate to the interest that an entity will have to pay. The lower the quality, the higher the interest rate. The higher the quality, the lower the interest rate.

As yields rise and decline, bonds react inversely, but at varying degrees according to their ratings. This spread between the rates of higher quality bonds and lower quality bonds is constantly expanding and contracting. Normally when rates are declining, the spread between higher quality and lower quality bonds is contracting. As rates are rising, the spread expands.

As an economy weakens, investors should to shift to higher quality bonds. As an economy recovers, investors can get more aggressive with lower quality bonds.

Current Interest Rates – Yields are set by the market, so they change daily. But trends develop based on what is happening in the economy. As inflation heats up, long term interest rates normally rise. As inflation subsides, interest rates decline.

Investors usually want to shorten maturities as interest rates are rising, and then lengthen maturities as interest rates are declining.

Strategies for Rising Rates

Since interest rates have hit lows not seen in decades, it is logical to assume that the next major move for interest rates will be up.

Bonds - If you must own bonds, then you should follow the suggestions above and shorten maturities and raise the quality of the bonds.

One strategy that works well is to ladder short term bonds. Let's say you have \$1,000,000 you want to put

Muni Insurers Collapsing



Both AMBAC and MBIA, the primary municipal bond insurers, collapsed over a year ago. What happens to the billions in bonds that had been insured if they collapse completely?

into bonds. A ladder strategy might have you put 20% in each year for 5 years. Then each year, as a bond matures, you put the maturing money into a 5 year bond (the last step of the ladder).

Although bonds are the primary investment choice for income, there are other investments utilized for income. They mostly all follow the same rules as bonds do when it comes to interest rates and the economy. As rates go up, market prices drop.

Preferred Stocks – Preferred stocks get a double whammy in the current environment because they are like bonds, but without a true maturity value. So when rates go up, the market price can get pummeled since the duration is so far out, if at all. But the double whammy happens when the issuer cuts or eliminates the dividend. When a company is having cash flow troubles, and today, there are many, one of the easiest ways to help cash flow is to stop paying dividends.

There is no appropriate strategy for preferred stocks at this part of the cycle. Interest rates may be bottoming and preparing for a long term rise. With the potential for many preferred stocks cutting or eliminating dividends, our research shows it is better to avoid this area

Key Points

- ◆ Earnings should be higher than the dividend on common stocks
- ◆ Bank CDs are for high safety, but give low rates of return
- ◆ Immediate annuity investors give up flexibility and control

all together. Even the best preferred stocks are hurt by rising interest rates, so none are worth the risks.

Common Stocks – For decades, many investors have relied on the dividends from common stocks. The most important benefit is that many companies can increase their dividend.

Unfortunately, the current environment is more prone to cutting dividends and declining stock prices. Until the bear market is over, and this may be years away, anyone that uses common stocks for dividend income is taking a risk of loss of principal and income.

Dividend yields may attract many investors into dangerous stocks today. The potential for a company to cut the dividend is high and with it comes a potential for declining stock prices. Companies with high dividends but low earnings are especially susceptible to dividend cuts.

Anyone investing in common stocks for the dividend should be prepared for watching the stock price decline for a long period and the potential for the dividend to be cut or even eliminated.

Other income choices

Stocks and bonds are not the only choices for income. There are bank CDs and annuities among others.

Bank CDs are a good source of short term income and as a parking place for cash. Some investors may want more than the current low yields though. This is where they can get into trouble. Bank CDs are meant for investors that want a high degree of safety. With safety comes low returns.

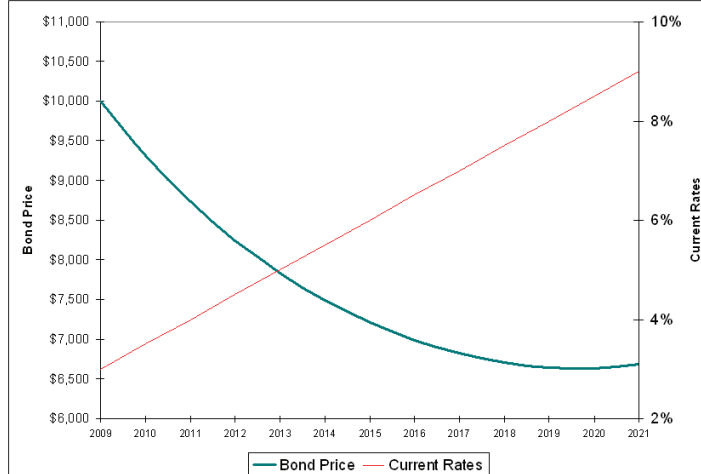
Unhappy with the low returns of CDs, investors can get themselves into trouble chasing yields and getting into investments that are unsuitable. This is a dangerous situation and one that the current low interest rate environment fosters.

CD investors need to understand that they have chosen safety of principal over income. If they want higher income, they must be willing to accept higher risks.

Fear can drive investors to make poor long term choices due to short term fears. Immediate annuities and annuity payouts from retirement plans can be poor long term investment choices.

Immediate annuities and annuity payouts from retirement plans are normally handled by insurance companies that pay out a fixed amount to the investor (or retiree) for a set period or the rest of their life. The monthly check is based on the person's life expectan-

The Effect of Rising Interest Rates on Bond Prices



The chart above is a hypothetical illustration of the market price of a bond and rising interest rates. The original purchase and face value is \$10,000. The coupon rate is 3.00%. The term is 20 years. The secondary market price is the blue line.

Interest rates hypothetically rise from 3.00% to 9.00% over 12 years and then stay flat. (This is not a forecast of future interest rates. We expect that rates will rise, but we have no indication at this point how high or how fast they will rise.)

You can see that the price of the bond declined for 11 years to a point where the investor was down almost 35%.

In this hypothetical, interest rates stay flat for the next 8 years and the value of the bond comes back up to the maturity value by the 20th year.

The best way to combat this from happening is to shorten maturities when rates are rising. The principal value will be much more stable on the secondary market and the investor will be able to follow rates up as they rise.

This is for illustration purposes only and is not meant to be a forecast of any specific bond or any interest rates.

cy. Sometimes the annuity offers a payout for a surviving spouse. This normally lowers the monthly check.

This is appropriate for the person that needs absolute safety of the monthly income and can't handle seeing their portfolio fluctuate even the smallest amount.

What the investor gives up is control and flexibility.

Once an investor signs up for a fixed payout from an immediate annuity or from a retirement plan, that payout stays the same for the duration of the term. If interest rates rise, they may not get an increase. If they need to take out additional money, they may not have access to their money. If they want to change investment strategies, they don't control the way the money is invested. If they want to stop or change the amount they get monthly, they may not be able to, they have given up control and flexibility.

(Some immediate annuities have limited options of

Strategy

- ◆ Shorten Maturities
- ◆ Increase quality
- ◆ Ladder bonds
- ◆ Don't reach for yield

increases for inflation and one time principal withdrawals, but these are determined by the insurance company meaning the investors still gives up control and flexibility.)

Conclusion

The purpose of this report is to show investors the risks regarding income investments that they may not be aware of and how they can reduce the potential risks. We are not giving specific investment advice to anyone in particular. You need to speak with a financial advisor to discuss how this information could impact your investments and how you can best utilize the strategies mentioned.

With rates as low as they are today, and the expectation that long term rates are going to rise significantly and for a long time, income investors today have few good choices. They have to be extremely careful and recognize the additional risks of today's environment.

The next major move for rates will likely be higher.

Our research indicates that strategies that worked for the past 27 years won't work going forward. Interest rates peaked in 1982 and have generally been declining since then. It is impossible for rates to drop as much as they did for the past 27 years over the next 27, 10 or even 1 year.

Income investors need to look for different ways of generating the income they need and Cornerstone has been able to do just that. Cornerstone has been creating income for investors for 10 years through a combination of dividends, interest and capital gains by using our actively managed portfolios and risk management strategies.

With the markets as precarious as they are today and with our research showing inflation is about to take off, investors don't want to compound their problems by looking for income in all the wrong places.

Let Cornerstone put our ten years of experience to work for you, helping you with your income needs.

Questions, comments, further information, to set up an appointment or request forms, call: Toll Free: 1-888-277-5968

(outside Rhode Island)

Providence Office:

(401) 453-5550

Dallas Office:

(972) 563-8990

Email:

johnr@cornerstoneri.com

**Cornerstone
Investment**

Services, LLC

**245 Waterman St,
Ste 301**

Providence, RI 02906

www.cornerstoneri.com

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