HELM
INVESTMENT MANAGEMENT

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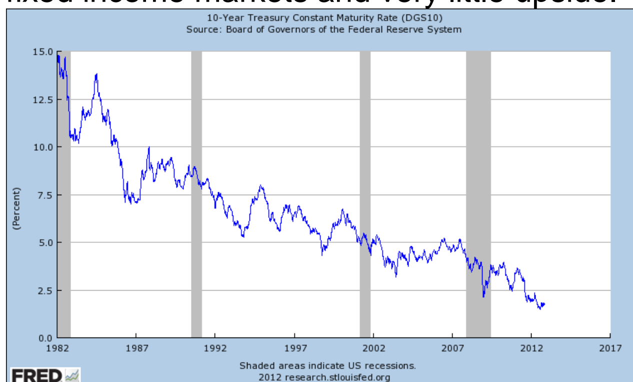
BURN BABY BURN!

The Fed may be doing a very good thing for the economy and jobs by promising to keep interest rates near zero until mid-2015. The Chicago Federal Reserve said that policy will continue as long as inflation is less than 3% and unemployment is 7% or more. This same policy, however, strangles investors relying on fixed income yield. Low interest rates have also created a potential bond fire that is about to ignite. As with any investment, it's important to understand bonds' inherent risk-reward characteristics.

Example: *consider a current ten year Treasury issued at par with a coupon of 1.625%.* Imagine that investors suddenly swoon over Eurofears or the pending "fiscal cliff" and 10-year Treasury yields drop a little to 1.25%, which would be a new low. The bond price at that point would rise to 103.50 or a gain of about 3.5%. Not much upside and very little gain for the bond holder. Now pretend that bond buyers focus on inherent risks in U.S. debt and demand a little more yield on that 10-year Treasury, a mere 2.5% coupon. The bond price would fall to 92.3, an 8% loss. That's significant and much more likely than interest rates declining. There is a lot of downside risk in the current fixed income markets and very little upside.



Most people buy bond funds, not individual bonds. The picture is even worse for bond funds. Check the Barclays aggregate bond index, which is 73% U.S. Treasuries, and agencies, primarily Fannie Mae and Freddie Mac. The rest is U.S. corporate and foreign bonds. It is an intermediate term bond fund likely to mirror most intermediate bond funds. The index shows that bondholder compensation for risk on U.S. government paper is extremely low. Both Treasuries and agencies are being supported by the Fed's Quantitative Easing 3 program buying up 70% of new issuance. In fact, spreads on mortgage bonds, once about 2%, have been cut almost in half since the Fed announced QE3. So intermediate bond funds are expected to drop more than our example if either fear goes up or Treasury buying goes down. At least with the individual 10-year Treasury, investors get principal back in 10 years. A bond fund, though, has no maturity date. The bonds in a fund just roll, so an investor may never get all the principal back.

Holding fixed income today is like holding cash. Decent yields are out there but in less traditional investments. Emerging market bonds have higher returns and less risk than our own bond market. Corporate bonds are possibilities. Preferred stock, utilities, MLPs and REITS are paying 4% to 8%. But let's not fool ourselves. MLPs and preferreds are neither fixed income nor government guaranteed. They are high-income equities with specific risks. Even so, we believe alternative yield returns are greater, and the risks are less, than the current fixed income market, which is set to badly burn those who own bond funds or bonds maturing in the intermediate or long term.

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