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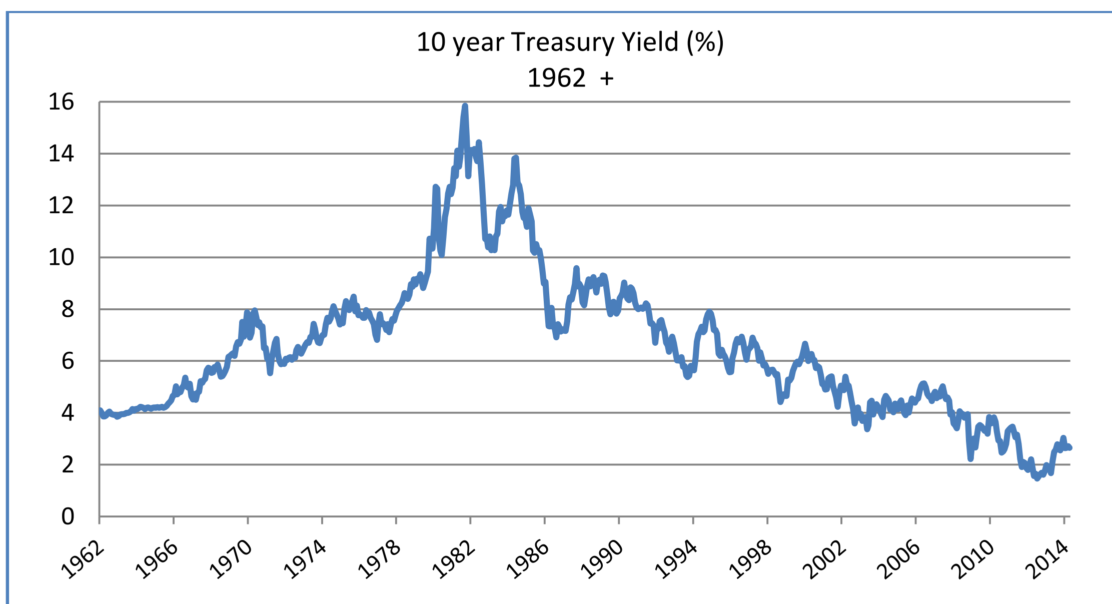
The Income Dilemma

Peruse any rudimentary book on investing and a common theme will likely appear: investors should diversify, owning a blend of assets representing exposure to various markets. Agreed.

These assets may include domestic equities, international equities, real estate, commodities, and fixed income. Bonds are especially valuable as a diversification tool in that they typically offer low correlations to equities, and high levels of current income. These dual benefits provide downside protection while smoothing out returns, dampening the strain of excess volatility. Simple enough.

But what if bonds are overpriced, if the bond market itself is unattractive? Things get complicated, and that elementary investment book will offer little guidance.

This is where we are today. Yields on the benchmark 10-year Treasury are hovering around 2.6 percent. An investor holding this note to maturity can expect that, by the year 2024, his principle will be returned in full, and he will receive ongoing interest payments offering a slight premium to projected inflation. If inflation re-accelerates, the real return will be negative.



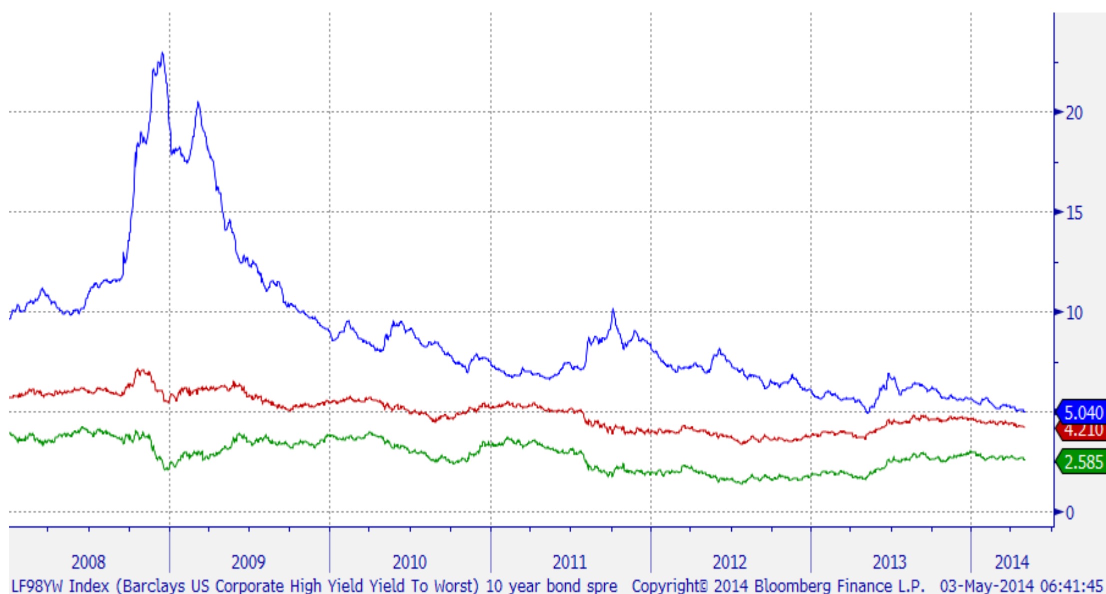
Before taking the plunge, an investor should consider that, since 1962, the yield on the 10-year Treasury has been lower than its current level only five percent of the time (monthly data). The average yield over this same timeframe has been 6.5 percent. If we exclude the double-digit interest rates of the hyper-inflation era, the average yield is still 5.8 percent, more than double the current rate.

The first downside to this investment is that interest rates will eventually move higher, driving bond prices lower. The second downside is that higher inflation could destroy the purchasing power of the principle, and ten years is a long time to endure an inflation threat. The third risk is opportunity cost -- the money could be better invested elsewhere.

The upside is limited. In a crisis, Treasurys will outperform most investment alternatives, with yields again nearing two percent. That rings of fighting the last war. More likely, rates could hold steady in a tight range; investors can clip coupons and be satisfied with a nominal yield under three percent, a real yield barely one percent. As upsides go, that's about as dull as it gets. Wake us when the paint dries.

This low-rate environment is not exactly new. Since the credit crisis and the great recession, yields on Treasury notes have consistently held below four percent. What's new are the paltry rates offered by alternative fixed income investments, including quality corporates and high yield bonds. High quality corporate bond yields have fallen from 6.5 percent to 4.3 percent in the past five years.

Yields: 2008-present
10-year Treasury (green line), Moody's AA bond index (red line), High yield index (blue line)



In the high yield market, the rate drop is much more dramatic, with yields falling from over 20 percent at the height of the financial crisis, to ten percent in 2011, to five percent today. At the same time, the interest rate spread on high yield bonds versus Treasurys has narrowed to an all-time low. One of the great investment opportunities of the credit crisis -- owning high yield bonds -- has become a greater fool game.

What's an investor to do?

Accept the reality. For the past quarter century, Treasury notes have returned nearly seven percent per annum; yet the expected annual return for the next decade is under three percent, and that is before inflation and taxes. An income investor can only take what the market offers, and right now that means meager returns.

Don't over reach. An old adage says: "More money has been lost reaching for yield, than at the point of a gun". Common mistakes in low yield environments include extending maturities and lessening quality. The longer maturities produce higher current income -- a 30 year bond yields more than a 10 year note -- but at significantly greater price risk. The inherent risk of lower quality debt, including high yield or foreign bonds, is simply not rewarded today with sufficiently higher yields. At current levels, if Treasurys look unappealing, high yield debt looks outright dangerous.

Limit exposures. Reconsidering that rudimentary investment book, the long-standing rationale for fixed income securities in a diversified portfolio is sensible. But it cannot exist in a vacuum. Price always matters, and today's bond pricing favors the borrower, to the detriment of the lender.

As much as we favor diversification, price and value trump all else. In the past few months, we have significantly reduced exposure to quality and high yield corporates bonds; while avoiding Treasurys and foreign debt altogether. Our fixed income and alternative income exposure is now smaller and more selective than it has ever been. Until something changes, it will remain that way.

Government Work

Part I

The 2009 economic stimulus package promoted by President Obama included $5 billion to weatherize some 607,000 homes -- with the goals of both spurring the economy and increasing energy efficiency. But the project was required to comply with a statute called the Davis-Bacon Act (signed into law by President Hoover in 1931), which provides that construction projects with federal funding must pay workers the "prevailing wage" -- basically a union perk that costs taxpayers about 20 percent more than actual labor rates.

This requirement comes with a mass of red tape; bureaucrats in the Labor Department must set wages, as a matter of law, for each category of construction worker in each of three thousand counties in America. There was no schedule for "weatherproofers." So the Labor Department began a slow trudge of determining how much weatherproofers should be paid in Merced County, California; Monmouth County, New Jersey; and several thousand other counties.

The stimulus plan had projected that California would weatherproof twenty-five hundred homes per month. At the end of 2009, the actual total was twelve.

Reprinted from the Wall Street Journal
Philip K. Howard, from his new book "The Rule of Nobody: Saving America From Dead Laws and Broken Government" (Norton, 2014)

Part II

There was no honeymoon for newly-appointed General Motors' CEO Mary Barra. Just months into the job, Ms Barra has played the role of company spokesperson, apologist, and sitting-duck target for anyone willing to take a free shot.

The public anger is justified, as the auto giant is in the midst of a recall program totaling seven million vehicles. The highest profile cases involve faulty ignition switches on some 2.6 million cars, a long-standing but unreported problem, and the cause of an estimated 13 deaths.

Cost of the recalls are projected at 1.3 billion dollars. Legal settlements will likely exceed that level. Two GM engineers have been placed on paid leave, and several high-level employees have left the company in a management shake-up. GM has hired both an investigator and a legal-settlements expert to bring outsiders' perspective to a broken internal system. The Justice Department has initiated a probe, and the National Highway Traffic Safety Administration is also investigating.

In the spirit of piling on, it was no surprise that Congress stuck its nose in the mix. Ms Barra was called to Washington for two days of Congressional grilling to answer for GM's mis-handling of product safety.

Here's the catch:. Ms Barra was the wrong person to call before Congress. These problems did not take place on her watch, but they did occur when the company's controlling shareholder was the US government. It seems more appropriate to call as witnesses the former General Motors CEO, former Treasury Secretary and former car czar; more appropriate that is, if Congress is interested in anything more than a photo-op.

Besides the obvious safety issue, perhaps the trio can explain why billions of dollars of GM stock was sold to the public without any disclosure of this liability. Surely this isn't too much for public shareholders to ask.

Part III

Illinois Governor Pat Quinn proposed making permanent a temporary income-tax increase initiated in response to the recession of five years ago. The Governor claims the money is needed to prevent deep spending cuts and continue stabilizing a state plagued by fiscal problems.

Illinois has the lowest credit rating among U.S. states and one of the highest unemployment rates. That won't stop it from trying to tax its way to prosperity. We can sympathize with the people of Illinois, although as voters they had a hand in this.

As for Governor Quinn, thanks for reminding us that, to government, there is no such thing as a small and temporary tax hike.

Part IV

As if there wasn't already reason enough to despise the Internal Revenue Service, this recent story emerged: A government audit reveals that IRS employees disciplined for misconduct still received performance bonuses totaling millions of dollars. It's nice to know that despite perpetual deficits, the federal government still has the wherewithal to hand out extra cash with minimal discretion. As it ends up, some two-thirds of the 98,000 IRS employees receive bonuses, and the standards must be pretty lax.

Among those sharing in the bounty were over 2,800 workers whose misconduct ranged from misuse of travel cards, violation of official-conduct standards, and fraud. There was one other behavior cited: failure to pay taxes owed to the federal government. To the world outside of Washington, this sounds like tax evasion. Nice to know it warrants a bonus.

Part V

The White House was giddy after recent reports that eight million people have signed up for private health insurance under Obamacare. So giddy in fact, that the Administration practically performed an end-zone victory dance worthy of a penalty for excessive celebration.

Presumably the eight million figure is seen as validating the health care program, as it exceeds the government's target of seven million enrollees by this date.

What the total really proves is that the administration picked an arbitrary target number, a low-ball estimate, which it was able to beat. So they are not as dumb as we thought.

Limiting information is a sure way of controlling the spin on any issue. We still don't know how many of the eight million enrollees were kicked off a prior health care plan, or are paying more for insurance than they did a year ago. Nor do we know what percent have paid more than one monthly premium. Anyone can sign up for health insurance; that doesn't mean they are happy about it, or intend to pay for it. And we don't know how much money this has saved. After all, Obamacare was supposed to be about government-instituted efficiency. You can laugh if you want.

As for the Administration's excessive celebration, the great coach Vince Lombardi famously quipped: "When you get to the end zone, act like you've been there before." Perhaps that's just it; when it comes to public policy achievement, they haven't been there before.

Source:
Bloomberg
Wall Street Journal

Tidbits..

Mt. Gox, major Bitcoin market based in Japan, goes bust.
Internal Revenue Service says Bitcoin will be taxed as property, not as a currency.

Bitcoin: an alternative currency, or a virtual tulip bulb?

Facebook to purchase WhatsApp for 19 billion dollars.

Half a billion users, little revenues, no worries.

New Jersey joins Texas and Arizona in opposing Tesla direct-to-consumer auto sales, protecting franchise dealer network.

Strange bedfellows, as liberal northeast protectionism aligns with conservative southwest protectionism.

China internet giant, Alibaba, to launch IPO in US.

Revenge of US markets, once seen as vulnerable to overseas competitors.

Federal Reserve continues to taper its QE3 bond buying, alters guidance on policy rates, and suggests accelerated schedule for rate hikes.

Markets care, and should care; but Fed watching has become the nation's largest arm-chair quarterbacking game.

Five former Madoff aides are convicted of securities fraud in abetting his Ponzi scheme.

Citigroup capital plan, including dividend hike and share buybacks, is rejected by Federal Reserve.

Bank regulators prove how tough they are; or is it arbitrary and capricious?

FBI investigating high frequency traders under theory of insider trading.

A dubious claim, why not just change trading rules?

Five years after: US economy finally replaces the 8.8 million jobs lost in the great recession.

Congressional Budget Office projects 2014 federal deficit falling to 492 billion dollars, fifth consecutive decline as percent of US GDP.

Recent fiscal improvement provides political cover to Washington inaction on future obligations.

US homeownership rate falls to lowest level since 1995.
Mortgage lending activity drops to 14 year low as refinancing boom ends.

Housing: another growth engine, sputtering.

Men's Wearhouse to acquire Joseph A. Bank Clothiers, creating national chain of 1700 stores.
Pfizer proposes 100 billion dollar drug mega-merger with UK's AstraZeneca.
Global merger activity reaches highest level since 2007 as cash stockpiles, rising share prices and tax arbitrage spur deal making.