HOULIHAN
ASSET MANAGEMENT LLC

Deflated Income

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Finding income in a low interest rate environment

As the spectacular credit unwind continues, almost all of us are feeling the relatively painful effects of deleveraging. Whether it is small business owners trying to secure revolving lines of credit, first time home buyers getting pre-approval or major banks selling off assets to raise capital, the process is tedious and burdensome. As balance sheets are unwound, asset price levels fall (think more supply than demand) and interest rates inevitably plunge. The flipside of low interest rates is income replacement. With money markets yielding nil and CD's not much higher, retirees and those in search of 'safe' places to park cash are confounded. We thought this would be a good time to refresh our loyal audience on different types of fixed income products and the terminology.

Terminology

- **Interest rate risk -** Easily the biggest risk to a fixed income investor. As interest rates rise, the value of the bond, CD, treasury etc. fall. Not a huge concern if the investment is held to maturity as the investor will still receive their principle back (just with discounted dollars). Also referred to as inflation risk.
- **Credit risk –** Risk of loss due to the credit worthiness of the debtor. Obviously a AAA rated Treasury bill has far less credit risk than a D rated corporate bond. Yield is commensurate with the underlying credit rating. Pay close attention – easy to get yield starved in such a low interest rate environment.
- **Duration risk –** Duration[i] is the expected time an investor can expect to receive her interest and principle back. This concept is especially important for bond *fund* investors – the lower the number, the less sensitive the fund will be to change in interest rates.
- **Convexity -** Convexity[ii] is the sensitivity of a bond's price to a change in interest rates. More of a risk management measure; convexity is higher for low coupon investments than higher paying ones.
- **Laddering –** Laddering a portfolio simply means buying fixed income investments over the entire yield curve (1-30 years). As the short term investment comes due, you reinvest at the longer end of the curve to get a higher yield yet you'll always have money coming due to reinvest on the highest rate possible.

Basic Investments

- **Certificate of Deposits –** The most fundamental type of fixed income. Issued by banks and FDIC insured to $250,000. Safe, secure and low yielding. Not recommended unless you need a money market alternative.
- **Corporate Bonds –** A bit more adventurous – pay close attention to the underlying credit rating of the company. The lower the rating, the higher the expected yield. Any bond rated lower than BBB is considered junk (higher yielding).
- **Municipal Bonds –** These are bonds issued bond local and state governments for various projects. Lower yielding than corporate but are usually state and federally tax free. More advantageous for higher income tax payers to consider. Again, pay close attention to underlying ratings and the use of the funds.
- **Mortgage Bonds –** These bonds (GNMA, FNMA etc.) offer more appealing interest rates and are a play on the housing market. Very interest rate sensitive but have an implied guarantee of the US Govt. (whatever that's now worth). Because of their complexity and tax reporting complications, we suggest you let a mutual fund do the work for you.
- **Preferred Stocks –** Preferred stocks are senior to a company's common stock but subordinate to the company's bond holders. Usually pay a higher rate than the bonds given their inferior capital status.
- **Closed-Ended Bond Funds** – These are a basket of bonds bundled as an exchange traded 'stock'. Can trade at a premium or discount to the underlying NAV (net asset value). Usually have a higher rate of return given they use leverage to goose their yields. Pay close attention to the NAV and the amount of leverage utilized. Can be tricky and quite volatile.
- **Open–Ended Bond Funds** – Similar to their closed ended sibling but without the use of leverage and trade at NAV. These are bit more plain vanilla and more suited to the average investor.

Hopefully, we've given you a few alternative fixed income options to consider. By no means is this an easy environment to invest but there are opportunities. It's understandable that investors are yield hungry. Just be careful not to reach too long on the yield curve. Rates will eventually be going back up so don't tie your money up in lower yields – keep some liquidity. If there's a silver lining to today's financial crisis and recession, it's that we're likely to come out of it a more financially fit nation—that includes consumers, financial institutions and just maybe, the government.

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[i] Duration
[ii] Convexity