



Rates Rise, Bonds Fall: A Jolt Ten Years Out on The Yield Curve

After defying expectations (mine included) that it would crack last year, the 10-year Treasury seems finally to be suffering in earnest. Since early February, its yield has risen from under 4% to over 4.5% — keep in mind that for bonds, rising yields indicate *falling* prices — and its price is nearly 8% off its 52-week high.

A Risk Free Instrument?

Treasuries are considered “risk free” in nominal terms: their principal value is backed by the full faith and credit of the US Government (no snickering, please!), and the presumption is that only a cataclysm could jeopardize their repayment. Thus the 10-year Treasury is effectively free of *credit* risk.

Sources of Risk

It remains, however, exposed to other major sources of risk, such as **interest rate risk** (that a bond’s present value will fall as its future maturity value is discounted using a succession of higher interest rates), reinvestment risk (that coupon interest will be reinvested at lower interest rates than originally anticipated — not an issue given current trends), **currency risk** (that the capital markets will punish US dollar-denominated assets due to ongoing structural problems facing the US *vis a vis* trade deficits and fiscal profligacy), and **inflation risk** (akin to interest rate and currency risk, but more strictly reflective of falling purchasing power).

On three of these four counts, things still don’t look good for the 10-year. Interest rates across the yield curve remain quite low by historical standards (unsustainably so, if you believe in the power of mean reversion as we do), and the US just logged its second highest trade deficit and its largest budget deficit ever.

So What’s an Investor to Do?

There’s no truly risk-free asset in real terms, no silver bullet to protect us from the multiplicity of forces that would erode our wealth. There is a protective process, however — diversification — and within a diversified portfolio we currently favor some of the following.

Diversifying and Defensive Tilts

One measure which can be appropriate is investing abroad. Allen Trust has the buying power to get its clients commission-free institutional class shares in Templeton’s Foreign Advisor (TFFAX), Emerging Markets (TEEMX), and Global Bond (TGBAX) mutual funds (whose \$5 million minimums put them out of the reach of retail investors). These introduce a hedge against the US dollar’s troubles, but more importantly, they deliver a stake in markets with superior long-term prospects, generally reasonable valuations (prices relative to expected long-term growth in GDP and earnings), and economic cycles different from America’s.

The second measure is buying **TIPS**, or Treasury Inflation-protected securities. These, like the aforementioned 10-year Treasury, are fully backed by the US government, but they have an added feature: their principal value and interest distribution adjust with changes in the Consumer Price Index (CPI). (This might seem to be a magic bullet, but unfortunately it’s not, because TIPS remain prone to interest rate hikes not reflected in the CPI, to spread shifts, and to price volatility as inflation expectations fluctuate). Allen Trust usually buys TIPS indirectly, through institutional class shares in Pimco’s Real Return (PRRIX) fund.

The third measure is stock in high quality companies with a history of increasing their dividends at a pace that beats inflation. Here are some recent dividend hikes by Allen Trust Core Equity companies: **BP** +26%, **Citigroup** +10%, **Countrywide Financial** +16%, **Home Depot** +23%, **Kimberly Clark** +12%, **Pfizer** +12%, and **United Technologies** +26%. Such rising cash flows provide owners an incremental *and compounding* margin of safety. Moreover, a number of these companies enjoy significant overseas revenues.

Then there’s **cash**. It exposes you to inflation and currency risk, but insofar as it’s immune to interest rate risk, it’s a long bond’s fixed income antithesis. Warren Buffett’s Berkshire Hathaway ended last year nearly a third invested in cash equivalents — over \$43 billion on a \$135B market cap! While holding cash hurts (Jeremy Grantham has likened it to “chewing glass”), one could hardly conjure better company. **Bill Harris**