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Find Safe Yield In The Bond Market Minefield

By Hugh Lamle

After almost a decade of low interest rates, both individual and institutional investors are frustrated by low yields and starving for income. Maturing and called bonds have exacerbated this problem by forcing them to either hold cash or re-invest in lower-yielding issues.

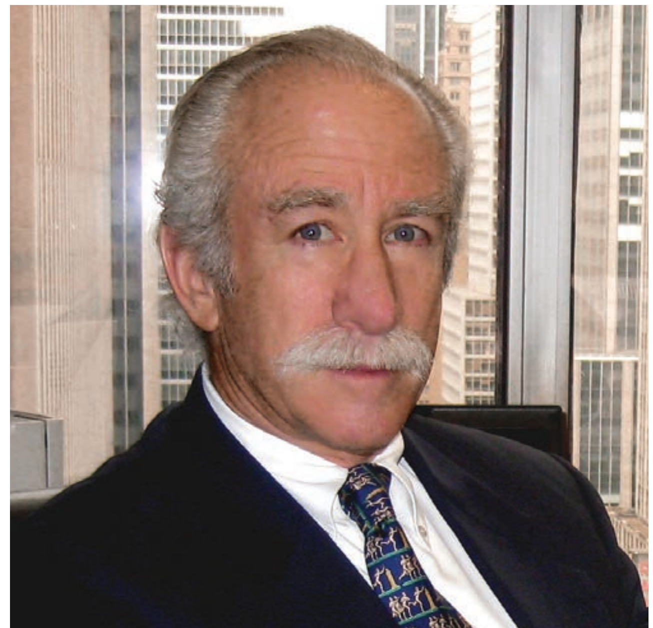
These investors face the unenviable choice of either extending maturities to earn more income, fully aware that even a small increase in interest rates will depress prices and wipe out several years of income; or parking their cash in money market instruments that provide almost no income while continuing to wait for higher interest rates.

Investors buying intermediate- or longer-term issues can reasonably expect interest rates to rise at some point before they reach maturity. As a result, they either have to be satisfied with minimal yields for the term of the bond or sell them before interest rates rise, but that requires a forecasting ability that few investors have consistently demonstrated.

A proven way of mitigating the negative impact of rising interest rates is to construct a short-duration portfolio so that when interest rates rise maturing bonds can be re-invested in higher yielding securities and the remaining short-term bonds are shielded from major price declines. Unfortunately, the current yields on high-grade, short-term issues are extremely low and money market issues yield almost nothing.

An improvement on merely having short maturities (two to five years) is to have a laddered portfolio with issues maturing each month so that as interest rates rise there isn't a one or two year wait to reinvest. However, except for the largest investors, it is impractical to have a portfolio of issues maturing monthly and internally generating cash flow to reinvest as interest rates rise.

The better alternative is for investors to buy U.S. government agency mortgage-backed securities (MBS) that were issued years ago when interest rates were higher. Like other bonds, these higher-coupon issues sell at a premium to par value. And because they are guaranteed by an agency of the U.S. government, credit risk is not an issue. In fact, during the global financial crisis, these issues had no down quarters even though one- to three-year U.S. Treasuries (generally thought of as the "go to" asset to reduce risk) had three negative quarters.



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higher coupons will receive par for that portion that is repaid. This risk can be mitigated, thereby providing excess return. The market generally prices in a substantial yield premium to reflect the refinancing risk. In many cases, however, it is possible to select pools of seasoned mortgages that have far lower-than-average refinancing risk and be paid the premium yield while mitigating the risk.

Most pools of mortgages have had substantial pay downs of principal as homeowners re-financed their home mortgages at successively lower interest rates during the past several years. The remaining mortgages in these seasoned mortgage backed securities are much less likely to refinance. Careful selection criteria are required. Among them are:

- Pools issued four or more years ago. Home owners have had many opportunities to refinance during this period. Those that have not yet done so, and meet the criteria listed below, are less likely to do so now and when interest rates begin to rise.
- Mortgages with low loan to value ratios. Again, these homeowners could have refinanced but have demonstrated that they are not motivated to do so.
- Pools that in the last 12 months have shown low monthly repayment rates on the remaining mortgages in the pool.
- Home owners with high FICO scores. These people could have refinanced but have chosen not to.
- Underlying mortgages with small balances. The costs of refinancing (appraisals, legal fees and the like) don't make sense for small balances.

There are other factors including but not limited to, geographic location and spread; the type of mortgage; government guarantee rates; availability and cost of private mortgage insurance that should be employed to carefully screen out mortgage pools with high refinancing risks.

An example of such a bond is FN AD3828, which is guaranteed by Fannie Mae. The underlying mortgages yield 4.4%. It was issued in April 2010, and 83% of the issue has already paid off. The remaining 17% is less likely to pre-pay at a high rate. In fact, in the past 12 months, even as interest rates dropped to record lows, the annualized monthly prepayment rate has averaged only 15.5%.

At a prepayment rate of 15%, the issue has a yield to weighted average life of 1.72% and even at a prepayment rate of 20% the yield is 1.40%, taking into account the amortization of the premium. Its duration ranges from 3.04 years at a 15% prepayment speed to 2.68 years at a 20% prepayment speed. These yields are far higher than comparable duration Treasuries, high-grade corporates and munis.

Another major benefit is that these securities pay monthly interest and principal. The above issue averages 2% to 2.5% per month of the remaining balance depending on prepayment spread. Therefore, as interest rates rise this cash flow can be re-invested monthly in higher-yielding issues instead of waiting 2 to 5 years for a bond to mature and getting less than 0.10% per month in income to re-invest while you wait. Essentially, they enable investors to dollar cost average into the bond market as interest rates rise.

Carefully selected, seasoned U.S. government agency mortgage-backed issues combine high yield, short durations, low interest rate sensitivity, high monthly cash flows and very high credit quality in a package that would be hard to duplicate in a laddered portfolio of Treasuries or even lower-credit quality muni's or corporate bonds. They are a very attractive alternative to intermediate and longer-term bonds, as well as money market funds.

HUGH LAMLE is president at M.D. Sass Investor Services, a leading investment management firm since 1972. The firm's assets under management exceeds $7 billion in hedge funds, private-equity funds, mutual funds and separately managed accounts.

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