Bond Market Reflections

Spring 2012

KOVITZ INVESTMENT GROUP

Capital Ideas.®

What We're Buying and What We're Not

For quite some time now, we have felt that bond prices couldn't go any higher – or put another way, that interest rates couldn't go any lower. But knowing that the only thing more futile than trying to time the stock market is trying to time interest rates, we only slightly modified our bond buying strategy by shortening our bond ladders from 10 years to 8 years. However, our disposition changed in February when the rates on 8-year municipal bonds dipped below 2% and yields on most 8 year high quality corporate bonds fell to the 2.5% range. At this point, we summoned our internal Roberto Duran and said, "No mas." Call it a buyer's strike. If faced with the prospect of loaning money out for 8 years knowing that our clients' best case return over that time was 2%, we decided that, for a while anyway, we'd rather our clients hold onto cash in hopes that pricing will become more rational over the coming weeks or months.

We are hesitant to say that the bond market is in bubble territory. While speculative bubbles seem to come and go in the financial markets, their common denominator is usually that investors don't recognize them until after they have popped. Second, bubbles generally involve more speculative assets where the bubble is fueled by the perceived, but ultimately illusory, potential for outsized profits, such as tulip bulbs in the 1600s or internet stocks in 1999. Given the limited potential returns currently offered by municipal and corporate bonds, the current prices of these bonds are that much more perplexing to us.

It was just a little more than a year ago when prominent banking analyst Meredith Whitney went on *60 Minutes* and proclaimed the sky was falling in the municipal bond market. Specifically, she said that we were going to see 50-100 major municipal defaults totaling over $100 billion in 2011. Her doomsday prediction sent bond prices down and yields up. At the beginning of 2011, we were getting yields close 4% on high quality 8-year municipal bonds. As each month ticked past and Armageddon did not come to pass, prices rose. By the end of 2011, prices had risen to the point that we were lucky to get 2.75% yields on the 8-year municipal bonds for which we were bidding. Nevertheless, we held our nose and bought them knowing that even at 2.75%, they were meeting our primary criteria in preserving principal for the "safe" portion of our clients' portfolios.

Then a funny thing happened in early 2012. Bond purchases, led largely by retail mutual fund investors, accelerated at the same time that the states decided they didn't need to borrow quite as much. The result was that 8 year yields plunged to under 2% for the first time in many of our lifetimes. It was at this point that we went from buying while "holding our noses," to sitting on the sidelines. In our opinion, the opportunity cost of forgoing additional purchases was lower than the minimal amount of income our clients could receive if we continued to buy.

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That said, there are exceptions. First, for the minority of our clients who are not subject to the alternative minimum tax (AMT), we are able to find yields on what are known as private activity bonds that often yield a full one percent more than is available on most municipal bonds. Typically issued by airports or state housing finance agencies, we believe the bonds we buy have a similar credit quality to that of many of the other municipal bonds we typically buy for clients. Yet municipal bonds subject to AMT trade at a discount to other municipal bonds solely because other advisors, and especially mutual funds, avoid them. Whenever the market is reacting to technical, as opposed to fundamental, factors, we are happy to take advantage of the mismatch between price and value.

Second, for clients with tax-deferred accounts like IRAs, profit sharing plans, or charitable foundations for which taxable bonds are appropriate, we continue to find non-agency mortgage bonds at discounts that we hope will allow clients to earn close to 6% on an annual basis (on average). Of course, there are no free rides – anything with higher yields is usually accompanied by a downside, and these mortgage-backed securities are no exception. What we find most interesting about these mortgage-backed securities is, in our opinion, they don't expose clients to materially more of the risks that we care about (credit risk - the risk of losing money, or interest rate risk – the risk of inflation/higher interest rates eroding the value of the bonds). Before we get to the risk exposure (which we care less about as long as we're being paid well enough), let us explain.

As to credit risk, those long-time readers of our newsletters know that we are not a big fan of the term "fixed income substitute." To us, fixed income should be the piece of the portfolio that we strongly believe is going to be there to provide stability when financial markets are being turned on their heads by the latest crisis du jour. You only have to look back to 2008 to see how high quality fixed income is supposed to perform. Our clients' bond ladders collectively returned over 4% that year.[1] Compare that to the many fixed income substitutes that Wall Street firms and others pitched as a "safe" way to earn a bit more than high quality bonds. Among the products that became fashionable were "low volatility" hedge funds, high yield (junk) bonds, preferred stock, real estate investment trusts, and even high dividend-paying stocks. You may recall that the common theme among these fixed income substitutes in 2008 is that they all had losses that resembled those of equities, rather than the bonds they were supposed to substitute. So when we say that we are comfortable that these non-agency mortgage bonds <u>are</u> indeed fixed income substitutes, we are saying that we believe the chance of a client losing principal (at the discounted prices at which we are buying them) is not materially higher than the risk of losing principal on municipal or corporate bonds. We don't use those words lightly.

Regarding interest rate risk, we believe that the mortgage-backed securities we are buying today have less interest rate risk than a typical bond ladder. There are two reasons for this. First, more than half of the mortgage-backed securities we analyze for potential purchase for clients are "post-reset" adjustable rate mortgages (ARMs). For example, if we are buying a pool of 5-year ARMs that originated in 2005 and which are now past the 5-year fixed rate period, those homeowners now have variable rate mortgages in

which the monthly interest payments made to bondholders will rise as interest rates rise. Second, even for bonds backed by fixed rate mortgages, the higher the yield at which we purchase a bond, the lower its sensitivity to changes in interest rates.

OK, so why are we able to buy them at discounts that should allow clients to earn 6% annually if we are telling you that we don't think we are taking a material amount of additional credit risk? And why do we believe that we are taking less interest rate risk? Two reasons:

First, they are complex, and many managers do not have the knowledge, resources, or desire to wade into this area of the market. Unlike agency mortgage-backed securities (Fannie Mae and Ginnie Mae, for example) which have relatively uniform underwriting standards, there is much less uniformity among non-agency mortgage pools. It takes a fair amount of time and effort for us to determine at which price we are comfortable bidding on a particular security. We have to know how many borrowers are delinquent, where the mortgages are located, the credit scores of the borrowers, the type of mortgages (30 year fixed, 15 year fixed, 5-year ARMs, etc.), when they originated, how real estate prices have changed in the areas in which the borrowers are located, how many borrowers are likely underwater, and the list goes on. From that data we need to extrapolate not just how many loans we think will default and when, but how much we expect to recover on each liquidation. Then we have to compare the likely losses that the pool will suffer to the amount of credit protection that is left. This latter issue of credit protection is complex, but the short version is that we are buying what are known as "senior tranches," and all losses are first allocated to the "subordinate tranches" until the subordinate tranches are wiped out. If that's not complicated enough, we also need to model in prepayments – mostly refinancings or sales which help returns (if we buy something at 80 cents on the dollar and the borrower refinances or sells the following month, giving us 100 cents on dollar at that point, it helps the rates of return). All that said, we would argue that the complexity is more our problem than yours.

Due to their complexity and other factors that limit the number of potential purchasers of these bonds, the second reason why we are purchasing them at a higher yield is due to their relative illiquidity. In addition to the illiquidity of the market as a whole, once we buy pieces of these pools and further split them into separate client accounts, it can be difficult to sell them at an acceptable level for an individual client. Therefore, these bonds have to be viewed as "self-liquidating investments," even if there is a point where we could round up the pieces allocated across individual clients and then sell them as a block. Each month, holders of these securities will generally receive both interest and principal payments. The principal component is made up of scheduled principal that is part of borrowers' normal monthly mortgage payments, and unscheduled principal, which includes both voluntary prepayments and amounts recovered from involuntary prepayments (aka foreclosure liquidations). On average, we expect clients to receive half of their principal back in 5-7 years – but there will be a small number of homeowners who never move, never refinance, and never undergo a foreclosure. We'd estimate that, on average, if we fast-forward 10 years from now (so in most cases we're more than 15 years into the life of the original mortgages),

approximately 10%-15% of the principal will still be outstanding. As you can see, these mortgage-backed securities can have some pretty long "tails." However, even assuming a hold-to-maturity mindset, we believe the loans remaining in the pool that long 1) will have substantially amortized down, 2) will likely have a very low current loan-to-value ratio, 3) will have a very low probability of defaulting (with an even lower probability of losing money on a forced liquidation), and 4) will have a relatively short, stable life from that point to final maturity.

But here is our point – and the reason that we'd <u>much</u> rather our clients take on some illiquidity than taking on credit risk or interest rate risk: in an IRA or other tax-deferred account from which you're not likely to withdraw assets until you are age 70 ½ (and even then, we assume the required minimum distributions will be much less than the amount of cash flow), we believe current liquidity is unnecessary or, at least, overrated.

For those of you who were reading our Investment Commentaries in 2009 and 2010, much of this probably sounds familiar – and it's likely that you own some mortgage bonds in your tax deferred accounts. What is new this quarter is that in some cases, we believe these investments may now be appropriate for taxable accounts. Last year, it didn't make a lot of sense to buy an illiquid mortgage-backed security yielding 6% for a taxable account that resulted in an approximate 4% after-tax yield because it was barely better than the 3.5%-4% our clients were generally earning on much more liquid municipal bonds. Fast-forward to today, and the spread between what we believe clients can earn on the mortgage bonds (~6% pre-tax or 4% after tax) versus the traditional municipal bonds (2%-2.5%) is large enough that such investments can be potentially appropriate for taxable accounts as well. We say "potentially" because even though we may downplay the need for liquidity in IRAs and other retirement accounts, liquidity may be more important to some of our clients with respect to their taxable assets. If you'd like to initiate a more personalized discussion about the merits of these mortgage-backed securities in a taxable account, we'd encourage you to contact your KIG advisor.

[1] The performance return ("over 4%") represents the 2008 composite performance, net of fees, of all fee-paying discretionary portfolios managed according to KIG's Tax-Exempt Fixed Income Strategy (the Composite). KIG employs a laddering strategy, typically ten years in length, and purchases investment grade municipal bonds for accounts in such Composite. The assets in the Composite in 2008 were approximately $125 million, which comprised approximately 13% of KIG's "firm assets" at the end of 2008. KIG's standard fixed income fee schedule is as follows: ½ of 1% of fixed income assets up to $5 million, and ⅜ if 1% of fixed income assets over $5 million, and is a negotiable rate. KIG compares its Composite performance to the Barclays Municipal Bond Index, which KIG believes is an appropriate benchmark, considering the characteristics of the Index (such as average maturity, duration, and credit quality). The performance of the Index in 2008 was –2.47%. The performance of the Index does not include deductions for transaction costs, management fees, and assumes reinvestment of income into the Index. Pas performance is not an indication of, and does not guarantee future results. Securities investments are subject to risk and may lose value.

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