ON THE MONEY

Desperate for yield? Review the basics of investing in bonds

Barry Ritholtz

ON INVESTING

I need some yield!

This is the battle cry of investors who have become frustrated with the low yields that the Fed's zero interest rate policy has created.

Indeed, last week saw the 10-year Treasury bond yields fall to near-record lows. This holding, the backbone U.S. bonds for most fixed-income investors, fell below a yield of 1.5 percent. And Federal Reserve chief Ben S. Bernanke gave rather dour testimony to Congress about his expectations for a weak economy in the near future.

The impact also was felt in equities, where, perversely, the bad news led to a stock rally. The traders' assumptions — Yeah! The economy is getting worse! — was that more weakness will beget another round of quantitative easing. That excess liquidity has a tendency to goose stocks higher.

But it is in the bond market where some very odd things are occurring. Buyers of the 10-year Treasury are agreeing to lend Uncle Sam money for a decade and receive a piddling interest payment of 1.5 percent. That is barely above inflation in the depressed environment, where price rises have been modest. It is reasonable to expect higher inflation in the future, but when that will finally hit is anyone's guess.

Given these low, low yields, perhaps it is time to revisit some of the basics about owning bonds, bond funds and ETFs (exchange-traded funds). We can also explore what alternatives exist regarding yield and generating income.

The most important thing you need to know about bonds is that they are essentially loans to some entity. As such, there are three main elements to any bond:

Quality: The credit worthiness of the borrower.

Duration: The length of the loan.

Yield: What the loan pays you in interest.

As is always the case in investing, there is no free lunch. If you want higher yield, you are either buying riskier bonds or lending money for a longer period of time (you can also use leverage, making a riskier investment even riskier).

There is something terribly disconcerting about so many people "discovering" bonds AFTER a 30-year bull run in fixed-income instruments.

My point of view on bonds as investments or income sources is simple. Here are five points to know:

1 Ladder: Owning individual bonds in a ladder — meaning a series of bonds that mature in successive years — is the correct way to own fixed income. By laddering bonds (2014-15-16-17, etc.), you are not tying up money for too long. If and when rates go up, you get to reinvest the specific holdings as they mature with higher yielding issues (note that if this happens, inflation is probably higher).

At present low rates, I prefer to keep my bond ladders to no longer than seven years. (This is much preferred to bond funds.)

2 Independent credit risk analysis: I work only with bond managers who do their own due diligence and have a deep research division. Do not employ any bond manager who relies on Moody's or S&P for credit ratings. These firms proved worthless to bond buyers in the last crisis. Indeed, their business models have radically changed. You and I as bond buyers are not their clients, but rather, the investment banks that underwrite complex products are the ones who pay their bills. Hence, their ratings are not objective, but rather are bought by and written for investment banks. Thus, we must learn from the last crisis when investors who followed the ratings agencies' "opinions" lost immense amounts of money. As investors, I am advising you to ignore everything they say and do: Your best hope is that the SEC figures this out and puts them down like a rabid dog.

3 Bond ETFs/Indexes: If you cannot afford a ladder, consider bond index ETFs. I like shorter-term Treasurys, high-quality corporate bonds and (non-bank) emerging-markets bonds. Note that the best of these are passive holdings that reflect a broad bond index.

What makes these superior to bond funds is that there is no risk of managers selling holdings for a variety of bad reasons. Sometimes redemptions cause managers to sell. Even the best of them, such as Bill Gross of PIMCO, simply made a bad call last year by betting against Treasurys. Sometimes the market causes them to panic. Index bond ETFs avoid all of that fund stupidity.

4 Bond funds have different risks from bonds: If you buy a quality bond and hold it to maturity, you will get your money back. Sure, a Treasury can move up and down, but held until maturity it will pay back its investment. Not so with all bond funds. If markets go topsy-turvy and a bond fund faces redemptions, they sell what they can, sometimes at a loss. Hence, it is another risk factor that you simply do not have in bonds themselves or bond index ETFs.

5 Income/Yield: Remember the first law of economics: There is no free lunch. You must be careful in chasing higher yield. Fixed income is supposed to be your safe money — what you must get back and what will cushion the ups and downs of the equity markets. Your first concern should be return of your money, and, second, the return on your money.

In other words, bonds are supposed to be your safety first investment.

You can create a higher yielding portfolio — one that generates more income than risk-free treasuries do. This means you are assuming more risk. If you are willing to accept that, including a possible loss of principal, then there are ways to build a portfolio that generates more income.

My caveat: I treat these holidngs like stocks, not bonds, which means that when they begin to misbehave, I kick them out of the portfolio. I always prefer selling for a small loss now vs. a big loss later.

If you respect those caveats, and can exercise some discipline in managing risky positions, here are a few places where you can look for yield:

Mortgage-backed securities: These were a disaster during the 2007-09 crisis. The working assumptions of buyers today is that the worst is over, and these mortgages are trading at a discount. Hence, that moderates the risk levels somewhat. Much of the subprime junk has already defaulted, so risk is out of them. Most people who were going to default on their mortgages have already. There is some truth to this, but there remains a healthy amount of risk in the space.

Corporate bonds: The safest of the non-Treasury bonds. Quality (non-junk) corporates yield between 1 to 7 percent. Corporate bond ETFs often hold hundreds of bonds, have low-expense ratios and yield more than 4 percent. Given that U.S. corporate balance sheets are as strong as they have been in a very long time, this is an attractive risk-reward relationship.

Junk bonds: Even higher yielding and, therefore, much higher risk. Some of these funds yield more than 7 or even 9 percent. They are much more vulnerable to specific failures of any company. Junk bond funds often see defaults that eat into principal. This should never be a large portion of any portfolio.

Master Limited Partnerships: Typically involved in extracting, shipping or storing a natural resource. They pass through 90 percent of their net income. Often, MLPs yield 5 to 8 percent. The problem investors have with these is they require a K1 tax filing, which most accountants hate. The solution is that there are now at least two ETFs that bundle 20 to 30 MLPs — no K1 filing needed. A risk is that eventually these resources are exhausted.

REITs: Are a type of fund that owns commercial real estate such as apartment buildings, office buildings and shopping malls. They get a special tax treatment that requires them (like MLPs) to pass through 90 percent of their net revenue. Yield can range from 3 to 8 percent. The downside is they are economically sensitive — meaning they don't hold up well in a recession.

Sovereign debt: Owning the bonds of sovereign nations comes with various levels of risk. If we ignore Greece and Spain and instead focus on nations such as Vietnam and Brazil, we can find higher yielding paper for modestly higher risk. Some closed end funds that do this use various levels of leverage. This magnifies the yield but also can magnify losses. If you own any of these funds that use leverage, stick with ones that use modest amounts.

Owning a yield portfolio is a way to obtain higher income but with appreciably more risk. Proceed with caution.

Ritholtz is chief executive of FusionIQ, a quantitative research firm. He is the author of "Bailout Nation" and runs a finance blog, the Big Picture. On Twitter: @Ritholtz. For previous columns, go to washingtonpost.com/business.

STEVEN PEARLSTEIN

Budget deal's path: CEOs and Simpson-Bowles 3.0

PEARLSTEIN FROM G1

By the time they realized it wasn't innocuous brinksmanship and began to engage, it was too late.

Although default was narrowly avoided, the damage to the markets and the economy was real. And subsequent events — the breakdown of the Obama-Boehner talks on a grand bargain, the failure of the congressional super-committee — have convinced a number of CEOs that they had to get involved, particularly with a fiscal cliff looming in January.

During the past year, there have been quiet meetings put together by chief executives such as Cote, Aetna's Mark Bertolini and JPMorgan's Jamie Dimon, and Senators Mark Warner (D) and Saxby Chambliss (R), the ringleaders of the bipartisan Gang of Six. Nudging it along and pulling it all together has been Maya MacGuineas, who for a decade has been sounding the deficit alarm from the Committee for a Responsible Federal Budget.

Last week, the group, calling itself Fix the Debt, went public at a news conference urging the president and Congress to embrace a deficit-reduction plan along the lines suggested by the bipartisan Simpson-Bowles Commission, which included reforms of a tax code that produces too little and entitlement programs that spend too much.

"Think of it as Simpson-Bowles 3.0," said former Republican senator Judd Gregg of New Hampshire, who is co-chairman of the effort along with Ed Rendell, the former Democratic governor of Pennsylvania.

In addition to Cote, Dimon and Bertolini, the charter business members include Sandy Cutler of Eaton, Gregg Sherrill of Tenneco, Marty Flanagan of Invesco, Gary Loveman of Caesars, Thomas Quinlan of R.R. Donnelley & Sons and financiers Steven Rattner and Pete Peterson.

Later that evening, at Honeywell's Washington office, over a salmon dinner with the floodlit Capitol dome as a backdrop, the executives huddled with their political co-conspirators: Simpson and Bowles, Warner and Saxby, and Rep. Steny Hoyer, the No. 2 Democrat in the House. Also on board: Simpson-Bowles commissioners Dick Durbin, the No. 2 Democrat in the Senate, and Andy Stern, former president of the Service Employees International Union.

In the next two months, the group aims to raise $50 million to $100 million, mostly from big corporations, to build public support for a debt deal and flush out its details so it can be acted on by Congress sometime after the November elections.

In many ways, this CEO effort is an end run around the elaborate and expensive apparatus that big businesses have set to influence the government in Washington, whether it be Washington offices staffed by company lobbyists or myriad business and industry associations to which they pay significant dues.

In today's highly partisan and polarized environment, the only way these business lobbyists can shape legislation or regulations of interest to their industry is to ally themselves with one party or the other and back that choice with a steady flow of political money to the party, its leaders and affiliated political-action entities. The natural choice for business has been the Republican Party.

The problem for Corporate America, however, is that the same Republicans who have been so aggressive and uncompromising in pursuing their agenda on energy or trade or corporate taxes turn out to be no less aggressive and uncompromising on issues that business may not agree on, such as eliminating federal funding for education, denying the existence of global warming or destroying Planned Parenthood.

Most significantly, while the vast majority of corporate executives would jump at signing on to a long-term budget plan that combines entitlement cuts with increased revenue, the Republican caucuses in both houses have repeatedly refused even to consider such a compromise. So does the Republican presidential candidate.

What would happen if a major company or industry group business organization were to break with the Republican caucuses and lobby for a bipartisan budget compromise? For starters, they might suddenly find that that amendment they were counting on won't be coming up for a vote after all. And if they persist in such disloyalty, the company lobbyist or top official in such an industry group might discover that there is a quiet effort to get them fired, replaced with somebody more loyal and reliable.

Crazy conspiracy theory? No, it's actually called the K Street Project, begun a decade ago by House Republican Leader Tom Delay. And if you doubt its effectiveness, just ask former Republican Congressman Billy Tauzin, who was pushed out as head of the Pharmaceutical Research and Manufacturers of America because he dared to strike a compromise deal with the Obama White House on health-care reform.

The reality now facing practical, pragmatic corporate executives is that their Washington lobbying apparatus has become one with a Republican caucus on Capitol Hill that is dominated by ideological zealots and uncompromising partisans. So if they have now concluded that the most important issue for American business, and the economy, is getting a reasonable bipartisan compromise on taxes and spending, their only choice is to bypass that apparatus.

Just for fun, go to the Web site of the U.S. Chamber of Commerce, which has become nothing more than a political money-laundering operation for the Republican Party. There you will find an endless stream of hysteria, histrionics and hyperbole demonizing Obama and warning of economic Armageddon if taxes are raised. And yet this is the same Chamber of Commerce that gets much of its income from the same corporations whose chief executives now consider a budget compromise involving higher taxes as their top priority.

(A similar dysfunction, by the way, exists on the other side, where labor unions and the AARP have joined with the leadership and Democratic caucuses in Congress to squash any talk of cuts to Social Security, Medicare and Medicaid as part of a budget deal. When John Rother, the longtime policy director of the AARP had the nerve to declare that some cuts were inevitable, it wasn't long before he was working somewhere else.)

So it's great that dozens of the nation's top business leaders have decided to join this fight and put some serious money behind it. They shouldn't waste their resources, however, trying to "educate" the public about the need to tame the deficit. For one thing, the country already gets it. For another, any advertisements they might run will get lost in the $2 billion tsunami of negative campaign ads that are about to break over an already cynical electorate.

To pull this off, my back-of-the-envelope calculation is that Fix the Debt will need to raise $278 million. That may sound like a lot of money, but it works out to one-third of one percent of the profits earned last year by the Fortune 500. More significantly, its enough to provide $1 million in political air cover in the next election to each of the 60 senators and 218 House members, Republican or Democrat, who have the courage to vote for a bipartisan budget compromise next year. And by the time the tea party, Grover Norquist and the AARP are finished with them, most of them will need it.

Even at $278 million, however, a credible budget deal would still provide the captains of industry a Bain Capital-like return on investment. The boost it would give to the economy and the financial markets would far exceed any stimulus proposed by either party or either of the presidential candidates.

As Robert Zoellick put it last week, quoting Australia's foreign minister: "The U.S. is one budget deal away from restoring its global pre-eminence."

pearlstein@washpost.com