

## THE DANGEROUS REACH FOR YIELD

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Interest rates have not been at such low levels in over 60 years. At the same time, the stock market is 19 months into a bear market. Investors have been desperately searching for yield as short-term yields hover near 2% and yields on longer-term bond issues trend near 5.5%. Unfortunately, as investors reach for higher yield, many do not fully appreciate the mechanics of the bond market and the attributes of a bond's total return.

There are several components of risk for a bond. Some of the most important include: interest rate risk, re-investment risk, call risk, default (credit) risk, maturity risk, inflation and liquidity risk. Investors who blindly reach for yield in their portfolios are often not aware of these risks. All of these risks are currently present with the risk of default being the most pronounced. Even so, there are diversified investment strategies available to investors looking to generate additional cash flow in their portfolio and, at the same time, preserve the level of risk necessary to keep them on track to meet their longer-term financial goals.

Today, there are a number of converging forces in the market that make it difficult for investors seeking to generate reasonably acceptable levels of income. The rapid slowdown in corporate profits and the overall economy has placed pressure on lower interest rates as a way to stimulate demand and lift the economy out of recession. Lower interest rates can be good for borrowers, but are not as attractive to lenders. Even with interest rates so low, many investors are not fleeing to equities. In the stock market, valuations are still high and the timing of a market-wide profits recovery is uncertain.

One method of boosting income return is to extend the maturity of the bonds in your portfolio. The risk of doing this is that the effect of interest rate changes is more pronounced for longer-dated bonds, meaning that the price of the bond moves more dramatically in relationship to bigger rate changes. As interest rates rise (fall), the price of a bond will fall (rise). Currently, the longest-dated bonds only offer a 3% premium over cash and cash equivalents. The odds are that interest rates will move even lower as inflation moves lower, making the extended maturity or duration bet less effective.

Another way to reach for yield is to bet on lower rated bonds or junk bonds. The problem with this method of enhancing income is that these bond issues can go into default (the issuer is unable to make timely principal and interest payments on the security) and the rate of default increases during down market cycles and economic recessions. Lack of liquidity is an issue as well. Investors who purchase high yield bonds for income return, be warned! Most professional high yield bond managers look for total return and potential credit upgrades. Many institutional investors classify these bonds as equities due to the equity-like risk.

Call risk is also misunderstood by many investors. Many issuers place provisions in the bond covenant that state that a bond issue can be called away at a specified date. If interest rates move lower, the bond will be called away from the owner, paying a lower coupon rate. Issuers of callable bonds offer higher yields to compensate for the added level of risk and to attract potential investors. Re-investment risk and interest rate risk oppose each other. Investors who roll over 6- or 12-month CDs are subject to re-investment risk if rates fall. Interest rate risk is the risk that interest rates will rise, thereby reducing the price of a bond.

With interest rates at historical lows, equity valuations and earnings still uncertain, and inflation falling, where should investors place their assets to preserve wealth and generate some reasonable level of income? Investors with exposure to both equity and fixed income assets in their portfolio should consider placing a portion of their portfolio in utility stocks, REITs and convertibles. The choice to use one of these securities or all three as a surrogate or complement to an existing portfolio depends on the individual investor's financial objective, time horizon, risk tolerance and liquidity needs. In many instances, liquidity and credit risk are much lower in these asset classes than in higher yielding corporate bonds. Investors should not ignore risk in seeking to achieve higher yield. Instead, they should look at more risk-controlled approaches of maintaining their ongoing income needs in this time of financial uncertainty. *f*