Capital Drain

Rick's investment opinion newsletter June, 2013 v.9 no.3

Before printing, think about the environment

Hi Readers,

Summer has arrived full force in California, and Fed-fed Frenzy has arrived full force on Wall Street. The former, you can enjoy by jumping in the water or playing in the sprinkler. The latter, after a moment to adjust your portfolio, you can ignore and go back to enjoying summer.

This will be relatively quick. In my opinion:

Executive Summary:

- The paradox of Fed Frenzy stock selling.
- Rising rates make bonds unattractive-- where will money go?
- Who will continue to buy bonds?
- The other cost of low rates- pension liabilities
- Review dividend stocks
- On the other hand, rising US rates will support the dollar

The recovery continues, and many US companies are doing well, but some prices reflect high continued growth expectations. If you're holding shares of any of the conspicuous high-fliers, especially the "hot" new tech IPOs, you might consider selling into this enthusiasm. Slow & steady for the long term will prevail.

As confidence in the economy spreads, investing in all-market index funds becomes more attractive. We are likely reaching the phase where a rising tide will lift (almost) all U.S. Boats. Other parts of the world will follow.

If you're inclined to pick among individual stocks, be conservative and be in the best of securities: stick to value and well-run businesses, shift away from bonds, and call me to chat if you're concerned about anything you're holding.

Above all, avoid the investments that are at all-time extreme valuations: junk bonds, developing-country bonds, and headline-grabbing stocks with high P/E ratios.

The Details:

The past couple of weeks have seen big swings in the US stock markets, nominally because of increased anxiety that the **Federal Reserve** will begin to reduce its unprecedented massive support for the bond markets.

First of all, take a moment to appreciate the paradox of stock sell-offs caused by the ending of Fed rescue efforts. The Fed will only end its rescue efforts when it believes the economy has recovered enough to continue growing without the special boost of unnaturally low interest rates. If the Fed thinks the economy is recovering well, that should be good news, right? The stock market should go up, shouldn't it?

It didn't; it fell. Further, on previous end-of-low-rate moments after previous recessions, stock markets have fallen. Why is that?

One reason could be that big investors are afraid that the Fed is premature, that the economy is not yet strong enough to grow on its own. That's a legitimate concern, in the abstract. Since the Fed has not yet started raising rates, though, it shouldn't really cause a big sell-off. The Fed always moves incrementally, trying to gauge the effect of each change before deciding whether and when to move more. It isn't really worthy of a big stock sell-off.

A different reason could be that, as some of the Fed's critics have said, the Fed's low rates aren't really funding a Main Street business recovery anyway, but are funding a binge of financial speculation. If you suppose that speculators are borrowing super-cheap money to make leveraged bets on other investments, then the prospect of higher rates might make the speculators try to get out of some of their leveraged positions quickly. That's more like what we saw.

Sooner or later, though, all the variations of Quantitative Easing will end, and the Fed will eventually even raise the Federal Fund rate. All of that makes bonds less appealing, so we can assume that rational investors will sell lots of bonds.

Recall, though, that big companies and investors don't have mattresses to stuff unused cash into. When they sell one financial instrument, they basically have to buy another. **After you sell bonds, what do you buy?**

I suspect that a lot of investment money will move from bonds to stocks, supporting or even lifting the stock markets.

Now the other side of that coin-- if bonds are going to be losing value because interest rates are rising, why would anyone buy a losing investment? The key is holding bonds to maturity. Insurance companies, for one example, often receive cash on one date, with the prospect of having to pay it back at some future date. It makes sense for them to use the cash they receive to buy bonds that will mature on or just before that future date. Since they hold those bonds to maturity, they do not suffer a capital loss. They get exactly the yield they expected, which was the best yield they could get at the time they invested it.

Insurers, pension funds, retirees, and any other investors that want to put money away for a predictable future expense are still going to be active bond buyers.

Speaking of pension funds, that brings up another reason we should be glad to see these unnaturally low rates end as soon as practical. I assume that you've heard a lot about the problem of "**unfunded pension liabilities**". What you may have heard less often is that low interest rates make that problem much worse.

In a pension fund, just as in your retirement fund, the money paid in throughout the career of the worker is invested, and will be withdrawn over time much later. The earlier the money is invested and put to work, the more it is expected to have grown by retirement time.

Pension funds are strongly encouraged (required by law) to be very conservative in their investments, which traditionally means that they'll buy a lot of bonds. When even long-term bonds yield very little, though, as they have these past 5 years, then the growth of that investment is small.

In more normal times (and very round numbers) you could put $100 in a 30-year bond and get around $300 back at maturity. That's what pension funds depend on-- a long time for the money to compound, and a rate high enough that the compounding produces big numbers.

Lately, though, low rates mean that the compounding produces much smaller numbers. That leaves the pension managers with two choices: require that much more money be paid in up front, or-- what we've seen-- keep paying in roughly the normal amount in hopes that somehow the market will improve enough in the future to reach the required gains. The longer the fund gets both small payments in, and small gains, the bigger the shortfall, the unfunded liability, gets. In a nutshell, that's why many parts of the economy need for interest rates to get back to normal, market-determined, interest rates.

Long ago, in the October 2010 newsletter (middle of p. 5), I said I liked a selection of financially **strong stocks** that were paying **good dividends**. Those stocks have done pretty well. All but one have appreciated very nicely, and all have paid good dividends as expected.

Beyond expectations, two of them spun off other companies, so if you started with these eleven, you ended up with thirteen. First ConocoPhillips spun off Phillips 66 (PSX). Then Kraft reorganized so that most of the old Kraft became Mondelez International (MDLZ), and a small chunk was left as Kraft Foods Group (KRFT).

It is time to adjust. Mondelez and Phillips66 were created without the kinds of dividends we want, so I intend to sell them. Sanofi-Aventis has shrunk its dividend while appreciating, so I will sell it too. That's just sticking with the dividend theme.

More of a judgment call, AT&T and Merck are no longer earning the

		10/25/10		
ticker	name	price	div	yield
T	AT&T	28.36	1.68	5.94%
EXC	Exelon	41.33	2.1	5.00%
SNY	Sanofi-Aventis	34.84	1.63	4.71%
MRK	Merck	37.42	1.52	4.10%
PFE	Pfizer	17.62	0.7	4.00%
KFT	Kraft	32.47	1.16	3.60%
DD	DuPont	47.7	1.64	3.50%
COP	ConocoPhillips	61.34	2.1	3.41%
CVX	Chevron	84.87	2.88	3.40%
JNJ	Johnson & Johnson	63.98	2.16	3.40%
INTC	Intel	19.87	0.63	3.20%

		06/30/13		
ticker	name	price	div	yield
T	AT&T	35.4	1.8	5.10%
EXC	Exelon	30.88	1.24	4.00%
SNY	Sanofi-Aventis	51.51	1.3	2.50%
MRK	Merck	46.45	1.72	3.70%
PFE	Pfizer	28.01	0.96	3.40%
MDLZ	Mondelez	28.53	0.52	1.80%
KRFT	Kraft	85.86	2.64	3.10%
DD	DuPont	52.5	1.8	3.40%
COP	ConocoPhillips	60.5	2.64	4.40%
PSX	Phillips66	58.91	1.25	2.10%
CVX	Chevron	118.34	4	3.40%
JNJ	Johnson & Johnson	85.86	2.64	3.10%
INTC	Intel	24.23	0.9	3.70%

money they pay out in dividends by a comfortable-enough margin. They're good companies, and AT&T's dividend yield is certainly nice, but they're not the sort of "rock-solid dividend that won't be reduced" that I want. Thus, I plan to sell them too.

In summary: shortly I will sell my holdings of MDLZ, PSX, SNY, T, and MRK.

I've got a good idea what I want to buy to replace those, but I want to
a) check some more details, and
b) get this letter out while it's still plausibly on time.

I'll finish the analysis and send the next letter soon.

Finally, one last note about the near to mid future. The US is likely to get back to robust growth before any other major economy. Also, the Fed is likely to start raising interest rates well before other developed countries' central banks start raising rates. Both of these facts mean that the **dollar will likely rise** for a while against most currencies (and gold). Among other things, that delays the time when we'll want to move a balanced portion of the portfolio into stocks of other healthy growing countries. We'll watch for the time to come.

That's it for now.

If you have any questions, please write or phone. If you want to read more, the company web site has archived editions of this letter, lots of charts, and links to other interesting sites. There's also a web log where I discuss the process and progress of starting the mutual fund, along with occasional economic or investing thoughts..

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Take care,

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"Our doubts are traitors,
And make us lose the good that we oft might win,
By fearing to attempt."
--W. Shakespeare

A collection of fine industrial Boilerplate, but true:

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