Portfolio Watch

March, 2016

Veripax FINANCIAL MANAGEMENT, LLC

Email: Jerry.Verseput@veripax.net
Phone: 916-358-5635
Website: www.Veripax.net

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Getting the Timing Right

Since my wife and I began ballroom dance lessons last summer, we've been immersed in things like Rumba, Waltz, promenades, and 5th-position crossovers. Many people have asked whether that was me on Dancing With The Stars, but no, that was Gary Busey. When you're first learning to dance it's easy to make dumb mistakes, like attempting a Foxtrot turn when you're dancing a Tango (duh). To my dance instructor, that is just monumentally stupid, despite my repeated attempts at it. The timing is all off. But to anyone who hasn't taken a dance lesson the question would be……actually they probably wouldn't even have a question about Tangos and Foxtrots. And that brings us, of course, to the world of bonds.

Being Out Of Step

Selecting a bond fund should be pretty easy. After all, bonds are supposed to be safe, so it really just comes down to picking the one with the highest yield (not really). Most bonds now have yields that make investors wonder "what's the point," and that's why many people flocked to High-Yield Bonds over the last few years. Back when they were called "junk bonds" they seemed a little riskier, but they were, and still are, the only bonds paying any meaningful interest. Buying a high-yield bond fund last year, though, would be like trying to dance a Cha-Cha to an Alpine yodeling tune. Although many advisors argue that "you can't time the market," timing is actually very important when it comes to bonds.

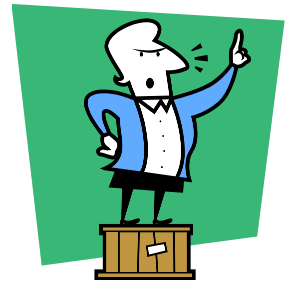
The Reference Point

I don't want to carry this analogy too far, but when dancing you need to know what the beat is. It's your reference point. When it comes to bond yields, the reference point is the current yield of Treasury bonds. Since the interest on a U.S. Treasury is

assumed to have no risk, the difference in yields between a Treasury and any other type of bond represents how much you are getting paid to own riskier bonds. This is called the "yield spread" (or just "the spread" if you want to sound cool). Sometimes the spread for a particular kind of bond is narrow, which means you're not getting paid much for the extra risk. At other times the spread will widen. Because of the relationship between bond yields and bond prices, this also means that when the spread is narrow, bonds are expensive compared to Treasuries, and when it's wide bonds are cheap. The widening and narrowing of the yield spread is like a beat, and if you start on the wrong beat you're going to look silly.

Where's The Beat?

Last year the yield spread for high-yield bonds became about as narrow as it's ever been, meaning that high-yield bonds were very expensive and the yield didn't match the risk. Not a good time to buy. That began to change very rapidly when interest rates bumped up a little and the fear increased that many energy companies, which use a lot of high-yield debt, could default. The result is that investors jumped out of high-yield bond funds like they were on fire, and now the yield spread is just as wide as it was during the height of the financial crisis, which is probably overdone. I got out of high-yield about a year ago, and now I've started to get back in. My timing may not be perfect, but I'm not doing a waltz when I should be doing a salsa. So the point is that something as seemingly simple as choosing a bond fund takes some work…and good timing.



Market Comments

The market did pretty well in February, and particularly in energy. Although oil is still less than $40/barrel, the price has risen 42% since it hit a low point on Feb 11. This is a great example of why it is so difficult to "buy low" and why many investors can not actually tolerate buying investments when they have fallen significantly. If oil now dropped from $37 back to $33, which is where it was less than 2 weeks ago, that would be more than a 10% drop. Pretty significant. However, relative to when oil was $115, that $4 drop would only be an additional 3.4%. Investments tend to get much more volatile after they have experienced a steep price drop because the price movements often reflect the higher price. At least for some period of time, the price has "memory." It sounds great to buy things when they're cheaper, but if you don't get in at the exact bottom (which is almost impossible), you need to be prepared for some volatility.

Even though Iran is still saying they will ignore all oil production limits, Saudi Arabia and other major oil producers are starting to make noise about slowing down a little. This would seem to indicate they are getting tired of losing money and may be an indication that the recent bump in oil is not just a dead cat bounce. As I mentioned in this month's article, high-yield bonds have started to look attractive as well, and they finally broke their downtrend. Not all high-yield bond funds are created equal, though. In contrast, I recently attended a seminar on fixed income where it was shown that a 1% rise in interest rates could result in an 18% drop in 20-year Treasury prices. The timing of bond purchases really does matter.

Despite the bounce in stock prices, the landscape for stocks is definitely not all clear. The effect of the presidential race on the stock market is muddier than a Republican debate, so I expect pretty high volatility for most of this year. That doesn't mean we can't own stocks. We just need to be smart about it.