The Tyranny of Low Rates

Ultra low interest rates may be the Fed’s best bet at preventing the economy from sliding into another recession, but for savers they represent a stealthy attack on the real value of savings. Money market funds barely pay anything at all, and even ten year high grade corporate bonds only yield 4%. After taxes that leaves very little real yield (i.e. after inflation) and no compensation for the risk of rising rates or any increase in default risk. In fact it would only take a 0.5% increase in long term rates to cause a sufficient capital loss in ten year bonds to wipe out a year’s worth of income. The fact that the Fed combined their announcement of Operation “Twist”, (buying long term bonds and selling shorter maturities) with an expression of concern over the U.S. economy was enough to trigger another round of risk aversion and a flight into the very bonds the Fed is trying to make unattractive.

The tyranny of low rates is the regime facing fixed income investors everywhere. High grade bonds have returned around 6% per annum over the past decade and have done that much just through the first nine months of 2011. But with yields at 4%, it’s pretty clear that the only way to repeat past performance is for yields to drop even further than they are now. A 1% drop in bond yields would cause around a 9% jump in prices, but the economic environment required to drive yields so low is unlikely to be friendly to many types of corporate risk.

There are alternatives. Investors should seriously consider reducing their conventional fixed income allocations. In any event, most balanced accounts will be below target on equities and above target on bonds following the sharp sell of in global stocks during the 3rd quarter. Rebalancing is generating bond sellers and stock buyers. But while this may push long term rates up a bit, the Fed is unlikely to contemplate raising short term rates until at least 2013.

As a substitute for bonds, we have three suggestions. Master Limited Partnerships (MLPs) pay distributions of around 6% and are likely to grow those distributions at 4-5% over the next year. It's enlightening to read through the public filings. One of our holdings in Magellan Midstream Partners (MMP). The tariff increases on pipelines that cross state lines are controlled by the Federal Energy Regulatory Commission (FERC) and annual rate hikes are linked to the PPI-FG (Produce Price Index for Finished Goods). Regular price increases linked to inflation are part of the reason MLPs can grow their distributions so steadily. MMP for example hiked prices on its pipeline network that runs down the center of the U.S. from Minnesota to Texas by 6.9% in July. MMP also provides an interesting way to benefit from the growing use of domestic natural gas in the U.S. since they continue to expand in areas rich with shale gas.

Barrons regularly writes about MLPs – a recent article highlighted the attraction of the sector.

Another place of refuge from low interest rates is a combination of cash and stocks. It needn't be as reckless as it sounds. The math can be quite compelling. Using ten year treasury notes which currently yield around 2% as an example: a taxable investor's $100 investment would grow to $113 after ten years. The same $100 could be allocated 80/20 between riskless three month treasury bills and large cap stocks. Putting only $20 into 2% dividend yielding stocks combined with a very modest 4% growth in dividends would also result in $113 of value in ten years. But this includes some very cautious assumptions – dividends ougfht to grow faster than 4%. They've grown at 5% over the past 50 years and companies are paying out a smaller share of their profits than in the past because it's more tax efficient to buy back stock or reinvest back in their businesses. And the $80 in treasury bills in this example may not pay any interest today but holding cash preserves flexibility to invest later when the future appears clearer or interest rates are higher. We’ve been discussing this strategy with clients. In effect the unusually high equity risk premium, the difference between the earnings yield on stocks and the interest rate on treasury securities, is making this possible as investors afraid of a repeat of 2008 seek safety in bonds.

Finally, it can be attractive to own a diversified portfolio of dividend paying stocks hedged with a short position in the S&P500. Stable earnings typically allow steady dividends, and such companies often have less volatility in their businesses and their stock prices than the market as a whole. $100 invested in dividend paying stocks can be made market neutral with around a $50 short position in an ETF such as SPY, hedging against short term price fluctuations but still allowing the investor to earn dividends and participate in dividend growth.

The Fed is making fixed income an unattractive hiding place. Prudent alternatives exist that offer the prospect of higher income with acceptable levels of risk.