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THE PETE ANDRESEN INVESTMENT NEWS

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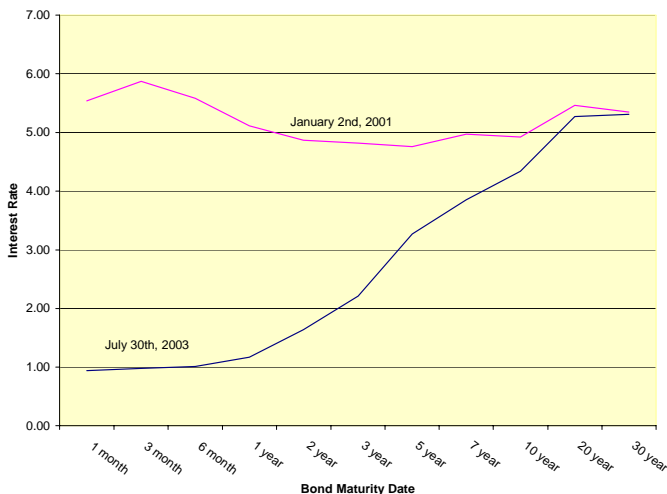


INVESTING IN RISING RATES

I have been studying and watching the bond and mortgage markets with growing concern. Our research has increasingly indicated the likelihood of a breakdown in the bond markets due to rising interest rates. With this breakdown, we expect a screeching halt to mortgage refinancing.

Below is a graph of yield curves. A “yield curve” is a graph of interest rates against the length of bond maturity. Investors sometimes demand a higher rate of return for longer-term bonds. When a steep yield curve like this happens, as it is now, it means that investors expect economic improvement and inflation. Classic economics teach us that when yield curves are flat, as you can see on this graph for January 2, 2001, investors are expecting little economic activity and little inflation.

Yield Curves on 1/2/01 and 7/30/03



As a result of studying this kind of data, we have grown more and more concerned about rising interest rates. However, we have also been concerned about moving out of decent yielding bonds too early. While our concerns grew, the bond market

continued to go up and rates continued to fall. Therefore, we merely moved money into short term bonds, which are at less risk. We did not sell client’s long term bonds unless we recognized overt credit quality danger. Instead, we tried to reap maximum gains in bonds without too much exposure to rate risk. If the client’s needs permitted, we even left assets in money market funds, which have been returning 1% per annum.

In the past three weeks, the average interest cost of a thirty year fixed mortgage has gone from 5.25% to 6.5%. Interest rates are soaring upwards. According to Morningstar Fund Manager of the Year Bob Rodriguez of the FP Funds, with whom I met recently in Los Angeles, we are witnessing the fastest decline in long-term bond prices in 20 years. Longer term bond mutual funds are being damaged. For example, American Century Target Maturities Trust 2025, which is full of ultra-long bonds, lost 9.6% in the past month. The more conservative Vanguard Long-Term Corporate bond fund lost 4.6%. Good thing we don’t own any.

The Mortgage Banker’s Association of America disclosed on July 30th that the rate of new refinancing applications fell 33% during the prior week. As expected, mortgage lending is stalling, at least for now.

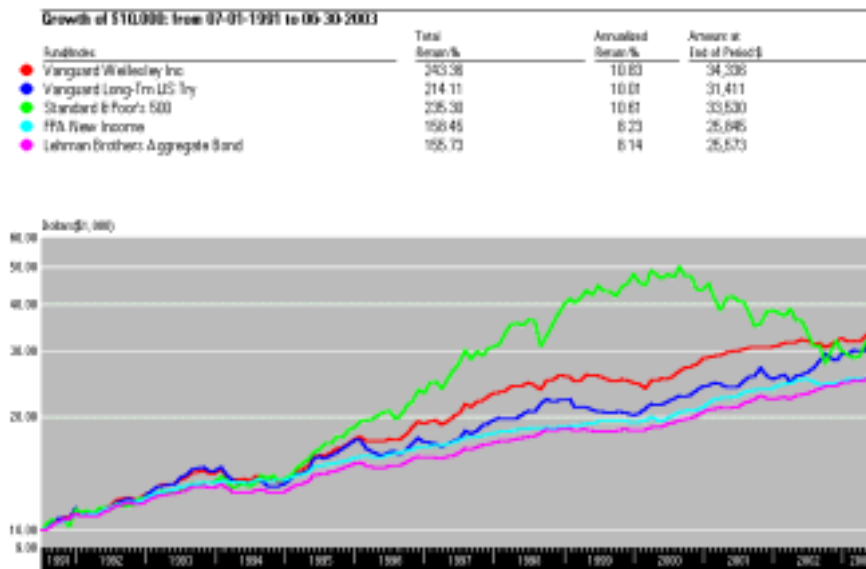
It is also important to note that bonds are declining from historic all time highs, and interest rates are rising from all time lows. On an absolute basis, bond prices are still high and interest rates are still low.

Because of our short-term bond positions, clients of Andresen and Associates are largely protected against this decline. Because we do not have much money in longer-term issues, we do not really have any reason to panic. Instead, we will wait for confirmation that the rising rates are permanent, and then make genuine long term changes. I am waiting for a few weeks to see that possible terrorist activity does not affect this scenario and to make sure that a genuine “sea change” in client portfolios is justified!

The more relevant question now is what to do to actually make money in the bond market during times of rising rates. Moving from longer-term to shorter-term bonds merely reduces damage; it does not actually make money. Instead, I have been looking for a response to what may become a long-term situation.

Until now I have avoided complex solutions because they have been unnecessary. Also, employing complex bond derivatives and trading strategies increases the risk that a manager or an issuer will make a mistake. However, it's time to look elsewhere if we are now in a new dimension where straight vanilla bonds are only able to reduce losses.

Here is our basic plan. I expect to modify it as needed in a few weeks as we learn what is actually happening.



1. Move a portion of balanced funds with longer bonds into balanced funds with less long-term exposure. Our favorite balanced fund with a long term bond position is Vanguard Wellesley Income fund. This fund has beaten the S&P 500 Index for the past twelve years and provides a yield of 4.3%, which is higher than most treasury bonds. As you can see on the graph, it's a long-term winner. It also lost 2% last week. If this decline continues, I am not going to let you ride it into the ground. However, since there is a transaction fee to move in and out of this fund, I want to have a long-term plan before we sell part of your position.

2. Move money from pure short-term bond funds into alternative or flexible bond funds. These have lagged the longer term bond funds, so most of them are “three star” rated by Morningstar at best. Nevertheless, they are a better choice in a rising-rate environment.
3. Use “Treasury Inflation Protected Securities”, also known as “TIPS”, for individual bonds or funds. These Treasury bonds provide a smaller coupon payment than straight Treasuries, but the principal is periodically adjusted upwards by the issuer in times of inflation. Therefore, in times of rising rates and inflation, TIPS provide a better overall return compared to straight Treasuries of equal maturity. We haven't used these before because TIPS bonds are very confusing and carry special, albeit mild, risks.
4. Invest more heavily in mutual funds specializing in stocks and convertible bonds that thrive in a rising rate environment. These would include dividend paying cyclical stocks, energy stocks, and stocks of commodity enterprises, such as wood, paper, metals, or (dare I say it!) even precious metals.
5. Stay in money market. This is not my first choice, but it's a good solution if rates unexpectedly continue to surge. If so, we will ride the rates up in money market and lock into higher yielding longer term bonds. If I keep a portion of your portfolio in money market, this will be an element of a long-term strategy.

I may need to rapidly reallocate money *en masse* to ensure that all clients get an equal purchase price. Please understand this and expect trades that I may not have been able to discuss with you in advance. Please call or email me now if this is an issue, and I will be sure to review any trades with you in advance, *after* I have carried out the block trades. This unusual behavior is necessary because we may need to focus on the markets with extra diligence. We may also need to make large strategic changes for many clients at once.

Whatever we do, we want to do it carefully, proactively, and with a spirit of contrarianism. This will be a process of months, not days. Let's stay diversified and press on!