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8/31/2010	Value	YTD %
Dow Jones Industrial Avg	10009	-4.0%
Vanguard 500 Index	96.9	-4.7%
Vanguard Total Bond Index	10.8	7.6%

THE BOND BUBBLE

The economic news continues to be mixed. “Mixed” does not mean bad. Reality may not be very popular since it contradicts our national sense of miasma. But the reality is that recent corporate earnings have often been... dare I say it... good. So far, anyway, results indicate an economy recovering slowly and unevenly, but *recovering* rather than falling back into a “double dip” recession.

Since our morose national mood may eventually create the very double dip recession which it most fears, I cannot say that a renewed recession cannot happen in the future. All I can say is that it did not happen when so many media pundits claim it happened: in the second quarter of 2010.

At the present, the stock markets appear to be accurately and attractively priced.

Meanwhile, in the midst of all this national economic drama, a new bubble, and thus a new threat, is emerging largely unseen in the financial markets. As is the case with all bubbles, it may go on for years, or it may collapse suddenly and catastrophically. That bubble is in the bond market.

If you are a client of Andresen & Associates, you probably own some short-term bonds.

If you think that bonds are safer than stocks, you are right... in the long term. However, current interest rate levels suggest that stocks actually present lower overall risk than long term bonds. Here's why.

A bond is a certain amount of money (the “face value”) which pays a fixed dollar amount (the “coupon”) on a predetermined schedule. As time passes, the bond eventually reaches a “maturity date” at which point the borrowed money is paid back.

So if the US government borrows \$10,000 at 5% for 30 years, they agree to pay 5% a year, or \$500, on that loan. After 30 years, they pay back the \$10,000.

Bonds deal with two types of risk: default risk and interest rate risk.

During the financial meltdown of 2008, we were dealing with issues of default risk. Many people couldn't pay their mortgages. Many corporations could not make either interest or principal payments. Thus they were in default. Bond prices plunged, and stock markets fell as well.

That risk has largely receded from the public consciousness, although it remains very real.

Seeking safety away from mortgages, corporate bonds, and the stock market, investors have gorged on what they believe are relatively safe Treasury bonds. As happens most often in bubbles, most of the buying has taken place recently.

We know that about \$375 billion went into all sorts of bond mutual funds in 2009. Three-quarters of that was from individual investors.

As you read in a newsletter a few months ago, we also know that individual investors are dismal at market timing.

The money moving into bond funds during the entire previous decade was about \$425 billion. (SEE GRAPH)

In fact, all these investors are half-right. The credit risk to a holder of a thirty-year Treasury bond is in reality very low. So they aren't entirely crazed.

But what happens to that 30 year Treasury bond if rates go **up**? *When interest rates go up, all pre-existing bonds go down in value, regardless of credit risk.* Sometimes they go down a lot.

For example, let us assume as before that the US government borrows \$10,000 at 4% for 30 years. They agree to pay 4% a year, or \$400, on that loan. After 30 years, they pay back the \$10,000.

The interest rate for a 30 year bond then rises to 9%. What happens to the price of that 4% bond?

\$400 is 9% of a bit more than \$4,000. The reality isn't that catastrophic because the bond has a maturity and expectations affect price. But I HAVE seen 30 year Treasury bonds drop 30%. That means that your \$10,000 bond is worth \$7,000, unless you choose to hold it 30 years until it matures.

Complicated? You bet. But regardless of complexity, the simple reality is that millions of Americans are fleeing the carnage of the mortgage, corporate bond, and stock markets to the perceived safety of Treasury and other government bonds, only to face profound interest rate risk.

But aren't Treasury bonds safe? Yes, they **are** safe in terms of credit risk. In other words, they aren't likely to default. That is, it is unlikely that a Treasury bond will not pay an investor interest or a return of principal on the maturity date. But Treasury bonds are as exposed to interest rates as the Titanic to an iceberg.

History suggests to us that as far as interest rates and the bond markets are concerned, there is an iceberg out there somewhere.

Here's what I'm doing in your portfolios:

1. I am investing your money only in mutual funds. By doing this I am adding diversification and flexibility to your investments.
2. You may have noticed some trimming recently. I am selling bond mutual funds with longer-term holdings, and keeping the average maturities of your bond funds as short as possible. So long as interest rates stay down, you will make less money than you will by investing in a longer maturity bond fund. You will also lose a lot less when and if interest rates suddenly surge.
3. In your stock mutual funds, I have reduced your exposure to industries which are interest-rate sensitive. These include REITs, financials, and real estate.
4. I am investing as much as 10% of your portfolios in energy and commodities. These tend to surge when inflation crops up with rising rates.

I emphasize that it is entirely possible that this bubble will pass without creating a catastrophe if interest rates rise slowly and gradually. In fact, a "soft landing" scenario is the most probable outcome. However, the potential devastation of an unlikely but possible spike in interest rates is too great to ignore.

Also short-term and high-yield bonds will be much less affected by a spike in rates. Therefore, we are not exiting the bond market entirely. Andresen & Associates is simply reducing your potential interest rate risk as part of a long-term rebalancing strategy.

Buy low, sell high. Right now long-term bonds are high.

