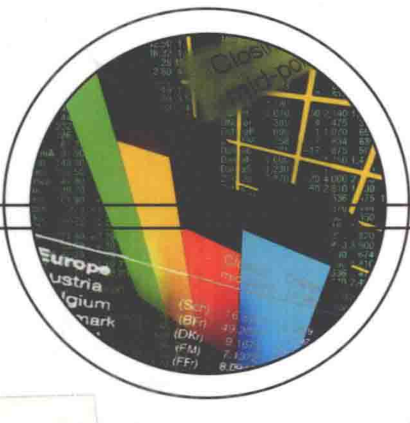
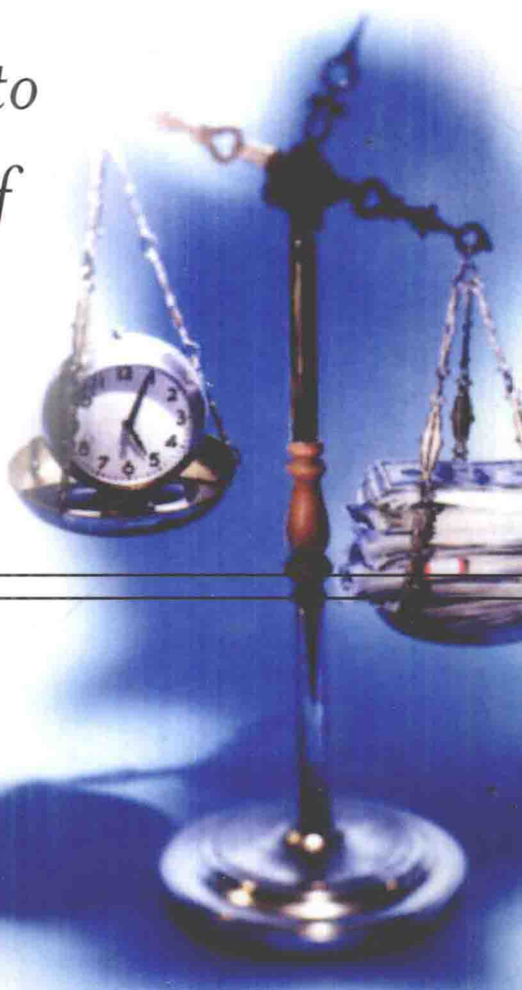
The STRATEGIC BOND INVESTOR

Strategies and Tools to Unlock the Power of the Bond Market





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Strategies and Tools to Unlock the Power of the Bond Market

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There are many people behind the life of every individual.

I dedicate this book to my supportive and wonderful wife and best friend, Cynthia; my three beautiful and enchanting daughters: Brittany, Victoria, and Isabella; to my mother, Anita, for her unconditional love, and to my father, Joseph, for all his encouragement; to my brother, Joe, and my sisters: Theresa, Gina, and Nicole; to my lovely grandmothers: Adelaide DiGeorge and Connie Crescenzi; to the memories of my grandfathers: Philip DiGeorge and Joseph Crescenzi; to my aunts: Phyllis and Linda; to my wife's parents, Evelyn and Joseph Montella, and to her sister, Cathy; to my Godparents, Diane and Jerry Antonellis; to my teachers: Mrs. Merlino, Mr. Marco Manfre, and Mr. Kircher; to my employers: Jeffrey Miller and Jeffrey Tabak; to Robert Koggan; to Walter Weil; to all my friends; and to the great city of New York.

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CHAPTER ONE

The Importance of the Bond Market

The bond market affects you more than you probably know. In many ways the bond market profoundly affects your personal life and touches the life of nearly everyone else. Its influence stretches well beyond the conventional wisdom in ways that most people are never aware of. In short, the bond market, where interest rates are set, is little understood yet immensely important to the national standard of living. It therefore behooves everyone to gain a better understanding of the bond market even if one is not a bond investor.

Throughout this book I will highlight the many ways in which the bond market affects you. I am convinced that when you have finished reading it, you will be surprised and enlightened and will look at the bond market in a new light. I will show you how you can unlock the power of the bond market. At the same time you will gain valuable insights into how the bond market operates.

You will learn important insights that are absent in other books about the bond market. More often than not those books are filled with information that is of little personal relevance to the reader, and they contain important but uninteresting and overly technical explanations about topics that most people can do without.

Of course, some technical content must be included in any book about bonds and the bond market, but that should not be the central theme of the book. Books about the stock market, for example, rarely delve into the intricacies of stocks and stock investing; they stick to what is relevant to the reader personally while making it interesting. That is what I will do in this book, and I will do my utmost to keep the topics relevant every step of the way.

THE BOND MARKET IS THE DOG THAT WAGS THE TAIL

When most people think about the bond market, it's an afterthought. Bonds are not very sexy to the average investor, and the bond market is either too complex or too uninteresting for most individuals to consider paying it much attention.

This should not be too surprising in this era of financial innovations, a secular bull market in the stock market, and a long period of economic prosperity.

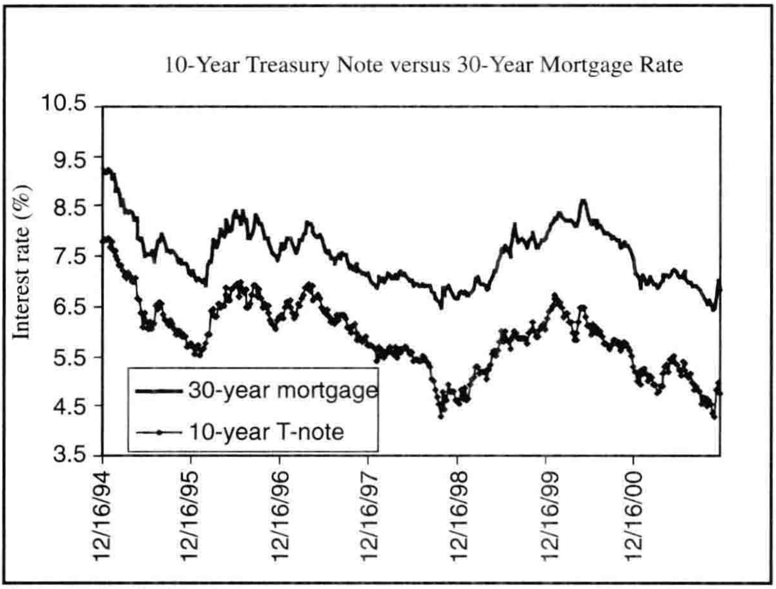
But this is where reality and perceptions clash: The bond market is really the dog that wags the tail. The bond market, and more specifically interest rate levels, significantly influence the behavior of the stock market and the economy, not vice versa. Since the stock market and the economy affect everyone somehow, a great deal of every individual's financial well-being can be traced to the bond market.

Unfortunately, many individuals miss this point and therefore miss the many opportunities that the bond market presents. These opportunities can surface in a wide variety of places, including home mortgages, home equity loans, credit cards, personal loans, car loans, the stock market, interest-bearing assets such as certificates of deposits and money market funds, the economy, international investments, and even politics.

THE BOND MARKET IS WHERE INTEREST RATES ARE SET

As was mentioned above, the bond market is where interest rates are set. The interest rate levels quoted on loans, credit cards, savings accounts, money market funds, and the like are all linked to the bond market. This is the case because they generally are correlated with an interest rate level set in the bond market. Most of these interest rate levels are linked to the U.S. Treasury market, the most actively traded debt securities in the bond market. Mort-

Figure 1–1



Source: Freddie Mac, Bloomberg

gage rates, for example, are tightly correlated with the yield on the 10-year U.S. Treasury note. Take a look at Figure 1-1.

As you can see from the chart, the 10-year U.S. Treasury note and 30-year fixed-rate mortgages basically move in lockstep with each other, with the 10-year T-note leading a bit. The tight correlation between the two illustrates the notion that interest rates are set in the bond market and shows the importance of following the bond market, especially when obtaining a home mortgage.

The reason so many interest rate instruments are linked to the bond market is the fact that the bond market serves as a reference, or benchmark, for where the investing public believes interest rates should be. In addition, the Federal Reserve sets interest rate levels that are reflected in the bond market. This will be discussed in greater detail in Chapter 6.

Because nearly all interest rate levels are dependent on the bond market in some way and since interest rates affect almost everyone in one way or another, gaining a better understanding of the bond market is a worthwhile endeavor.

Let's take a closer look at how the bond market affects many important facets of our daily lives. As you read on, think about the many ways in which your life has been touched by these powerful forces.

INTEREST RATES AFFECT PERSONAL FINANCES

For most households, interest rates have a large impact on everyday finances. In the United States, where debt is a big part of the way people live, this impact is largely manifested in a household's monthly bills. Americans are simply enamored of debt and use it to fulfill many of their hopes and dreams.

The explosion in consumer debt has resulted from the increased availability of credit and changes in consumer preferences. Demographic influences have been a critical factor too, as baby boomers—those born from 1946 to 1964—have increased their use of debt to tap into every possible means to finance their well-documented love of consumption of goods and services.

Whatever the reason, the fact is that on average most households have a significant amount of debt outstanding in a variety of forms. Table 1-1 highlights the enormous amount of household debt outstanding.

As the table shows, the total amount of mortgage debt outstanding surpasses all other forms of debt. This clearly indicates that the biggest way in which interest rates affect a household's finances is through mortgage rates. The mortgage rate directly affects every homeowner's monthly financial situation. I am sure that many of you can relate to this.

Table 1-1

Liabilities of the Personal Sector
(billions of dollars; source: Federal Reserve)

Type of Debt	Fourth Quarter 2001
Mortgage debt	5,741
Revolving debt	692
Nonrevolving debt	963
Other liabilities	1,883

Let's illustrate one way in which I learned firsthand how important interest rates are.

In 1989, the year before I began my career in the bond market, my wife and I bought our first house, a town house. It was a special time for us, filled with excitement. We were elated to be realizing the American dream of owning one's own home.

While the home itself was a great source of pride and pleasure for us, the financial side of the equation evolved in ways I did not envision at that time. We took out a mortgage at a whopping 11.25 percent, the prevailing rate at that time. I didn't give much thought to the interest rate level because I felt the price of the home would rise, as home prices always had, and offset the interest costs.

Was I wrong! As I came to understand, the Federal Reserve was in the middle of a campaign to slow the economy in an effort to stamp out inflation and a brewing price bubble in the real estate market. The Fed's rate increases therefore hit me with a double-barreled whammy: I was stuck with an 11.25 percent mortgage rate, and my home's price fell when the Fed burst the real estate bubble.

When the real estate bubble burst, the price of my town house fell 25 percent in short order. I tried to refinance for years, but no bank would consider it because my town house had negative equity. Therefore, I was stuck. For years I was saddled with high payments on an investment that had gone awry.

What do I know now that I didn't know then? For starters, I have learned that the interest rate I pay on debt matters—big time. Never again will I borrow money without giving strong consideration to interest rates. That means paying more attention to the bond market. Following the bond market has enabled me to make better financial decisions and plan better.

I have also learned to respect the adage "Don't fight the Fed." The Federal Reserve has enormous influence on the economy and, hence, my financial well-being. I can't emphasize this point enough. We'll learn more about the importance of respecting the power of the Fed in Chapter 6.

So now I have turned the tables. In my new home, my mortgage is just 6.375 percent. Instead of having the highest interest rate of anyone I know, I now have one of the lowest. By staying in tune with the bond market, I have learned to be opportunistic with interest rates when they fall. And by watching the Federal Reserve, I am more on top of the investment climate.

Stay in tune with the bond market as I have and keep the graph in Figure 1-1 fresh in your mind. Let it always remind you that the bond market can have a great impact on your personal finances.

CREDIT CARDS

Aside from home mortgages, interest rate levels have a great impact on the payments that most people make on their credit card balances. Some of you, I am sure, have obtained new credit cards with low introductory interest rate levels on balance transfers. Have you noticed the big difference that the interest rate level makes on the monthly interest charges? It can be staggering.

The attraction of credit cards with low introductory interest rates has been partly responsible for the sharp increase in consumer debt over the past 20 years. Opportunistic financial companies have capitalized on consumers' increased willingness to run up debt by developing various types of creative financing arrangements that entice consumers to take on more debt. And have they! Americans hold hundreds of millions of credit cards and have debit balances of roughly $700 billion. That is well above the level in the mid-1990s, when there was about $500 billion outstanding.

The pervasive use of credit card debt can be used to illustrate the large impact that interest can have in an individual's personal finances.

Consider, for example, a consumer who has $8,000 of credit card debt outstanding carrying an annual financing rate of 18 percent. That consumer will incur roughly $1363 in interest charges through the course of a year, assuming the consumer pays only the minimum payment (of the standard 2.5 percent). If the consumer transfers that balance to a new credit card with an introductory interest rate of 5.9 percent, the consumer will incur just $424 of interest charges over the course of a year. The difference is clearly significant.

Perhaps even more significant is the amount of time it would take for that consumer to eliminate the debt entirely, assuming the consumer pays the minimum monthly payment. If the debit balance