The Hidden Bond Market:
Better Than A Golden Parachute

By Jim Pearce and the team of analysts at Investing Daily

Investing in the bond market isn’t an all-or-nothing proposition. Even as trouble and turbulence hit select markets for bonds, there’s always a part of the market that’s bullish. So whether the economy is hot and heavy or dull and depressed, something will always provide value and positive investment performance, just like in the stock market. Every market has its cycles, even bonds.

During boom times for stocks, bonds are left to rot—only to be sought after with a vengeance during the plague of recession and bear markets. While market timers might advocate that bonds are only useful as defensive assets, the real truth is that bonds offer much more and can provide stellar returns in all market conditions, completely independent of the stock market.

Stocks are what most people think Wall Street is all about. But when the stock market hits the skids, the bond market is where you can actually make money. We’ve been giving this advice for some time, but buying bonds might be treading into the unknown for new subscribers. Let’s end that once and for all: Bonds aren’t tricky or boring once you understand the basics.

Bond Basics

Bonds trade on three characteristics in the markets. First is inflation; what it is now, and what it is expected to be in the future. The idea is that if inflation is falling, the current value of those future interest and principal payments will be worth more, driving bond prices up.

Next is credit quality. If the issuer is improving its credit rating, the market will attach a lower risk premium in yield, resulting in price gains. As the Federal Reserve makes it harder for companies and other issuers to fail, credit expectations should improve, driving yields lower.

Third—and this is important in the market now—is competition for assets. During periods when cash and stocks become less attractive for investors, bonds will have less to compete against, thereby moving yields
lower and bond prices much higher.

Bonds are simply promissory notes issued to borrow money from investors. Issuers can be governments or corporations. Governments represent the core of the bond market both in the U.S. and around the world, as they borrow to make up for revenue shortfalls or for large-scale projects.

Corporations that need to borrow money to sustain current operations, as well as to expand their capabilities, also will issue bonds. A bond consists of the principal owed at maturity and the interest to be paid until that date. Bonds range in maturities from a few months to many decades, with bills referring to maturities of less than one year and notes used for maturities between one and 10 years. But whatever the maturity, all are considered bonds.

When a bond is purchased, the buyer receives the interest typically through regular coupons, with the principal following when the bond matures. Interest is usually paid once a year, but some issuers, including the U.S. Treasury, pay investors semi-annually.

In addition to bonds that pay coupons, there are also bonds that pay interest only at maturity. These bonds are referred to as zero-coupon bonds, or strips.

When a zero-coupon bond is purchased, the investor pays a fraction of the bond’s maturity value with the difference between the purchase and maturity values serving as the investor’s interest.

For the uninitiated, often the idea of buying bonds is simply to buy and hold the bond to maturity and collect the interest. But bonds can offer much more—in some cases, they can provide returns that eclipse stocks. In the bond market, total return encompasses the overall effect of the interest paid as well as price movements in the value of the bonds themselves.

Buying bonds paying a fixed rate of interest and then selling them as yields fall is the best way to invest and win with bonds.

**Investing in Bond Funds**

The open-end (issues new shares continuously) and closed-end (finite number of shares) mutual funds in the following pages invest in the same types of bonds that are generating high cash flow now, with prices that could soar in the future. Each of these funds should appreciate as the bond market closes the gap in yield.

The valuation basics work the same way for diversified funds as for individual bonds. First, inflation is with us, but expectations by most experts remain subdued. This makes for lower inflation risk and higher bond prices overall.

Next, credit conditions are easy. With cash aplenty and lenders eager, the probabilities of default are reduced in the market for riskier bonds. This means less of a premium in yield will be demanded.

And finally, cash has been trashed sending money market yields to the floor while many stock market investors remain skittish. This means higher-yielding bonds become that much more beguiling, driving yields lower.

Falling yields mean rising prices. The longer the maturities of these bonds are, the bigger the impact on prices. The early stages of any market rally are fraught with risk, and the signals of change often are shrouded in the dark cloak of investor hibernation.

One of the best signals of change can be found in the bond market. When an economy is in a downturn, the central bank will decrease rates and offer monetary stimulus to jumpstart growth. Also, if the market is to be successful, the central bank will be joined by the legislature and executive branch, which will do their part to encourage confidence in the economy.
Getting Savvy

The bond market may seem boring to many investors, and Wall Street is always willing to push this issue while it peddles exciting stocks that generate commissions for brokers and losses for you. But what most folks outside Wall Street don’t realize is that bonds have a secret: They can provide double- and triple-digit gains for investors in the know.

While some investors buy bonds for the pleasure of collecting the interest payments, serious investors buy bonds to make real money. Investors profit as bond prices rise in response to falling inflation and improving credit in nations around the world. And one-by-one, markets in Europe, Asia and even South America are providing great opportunities to make real money in bonds.

Because many subscribers might be novices in the bond market, Personal Finance will help you understand the ins and outs of bonds. Nations ranging from Korea to Mexico and even the United States have bonds that pay 10% or more and should give you the opportunity to profit from rising prices—resulting in even greater returns.

Attempts to improve monetary and fiscal conditions, if successful, will be felt first in the government bond market, particularly in transitioning regions and emerging markets. Markets in nations with poor histories of positive economic stability will have bond markets that are in shambles. The cost of funding government expenditures will be sky high, as domestic bond markets will command high yields before they’ll lend to a troubled government.

Adding to the woes of a troubled market is inflation. Typically, if a nation has economic hardships, it will also be plagued with the high levels of price instability and inflation. Bad credit and high inflation make it not only prohibitive for nations to borrow but also limit companies from borrowing as well.

Better access to credit and higher credit ratings typically improve inflation, contributing to positive conditions for the bond market. As a nation gains recognition for its efforts, the market for its government bonds will receive positive attention. Rising bonds of a transitioning market initially reward savvy investors who entered the new market before supporting lower funding costs for the nation’s companies. The bonds of a new market rally first; then stocks follow later.

Buying bonds of nations just as they’re fixing their credit markets is a surefire way to profit from economic turnarounds. All it takes is the willingness to look beyond the stock market and mistaken notions about bonds to capitalize on the power of positive change in bond markets around the world, while Wall Street continues peddling its riskier stocks.

Wall Street has convinced most investors that the allure of investing in bonds ranks right up there with dieting, exercising and eating your vegetables—all good for you, but not exactly fun and exciting. Although all of these apparently unappealing activities can have a positive effect on your fiscal and physical condition, bond buying can actually be as exciting and stimulating as picking stocks.

Here are a few of our favorite ways any investor can get involved in the bond market right now.

**Bond #1: Vanguard Intermediate-Term Investment-Grade Fund**

On the conservative end of the bond market is the Vanguard Intermediate-Term Fund (VFICX). This fund has diversified exposure to medium and high-quality investment-grade bonds with an average maturity of five to 10 years. The fund invests in corporate bonds, pooled consumer loans and U.S. government bonds.

Due to its high quality and short duration, the share price of this fund seldom deviates more than a few pennies from one day to the next. Even still, its dividend yield of 2.7% is higher than what you can get from a 10-year Treasury note. We rarely say “buy at any price,” but this is an exception.
Bond #2: Vanguard High-Yield Tax-Exempt Fund

Another bond fund to consider is the Vanguard High-Yield Tax-Exempt Fund (VWAHX). The strategy of this tax-exempt municipal bond is designed to generate maximum profits while keeping Uncle Sam’s hands off your money. We love the fund because of its ultra-low expense ratio and its 3.7% tax-free yield—and you will too as the tax man passes you by every April 15.

You may be wondering how there can even be a “high-yield” market for municipal bonds in the first place, given that they are issued by state, county, and local governments. Shouldn’t all municipal bonds be highly rated, with the low yields that accompany low-risk bonds? Although most municipal bonds enjoy the highest credit ratings of AAA and AA, some bonds do not for a variety of reasons.

Some are “revenue bonds,” which are backed by a specific project, such as a nursing home or toll road, in which case future interest and principal payments are made only from the income the project generates. Others are issued by municipalities that are overcoming financial challenges that strained their balance sheets. For those reasons, a diversified mutual fund is the safest way to own these bonds to avoid the possibility of having too much of your money in any one issuer.

From a historical perspective, high-yield municipal bonds have outperformed higher-rated bonds due to the outsize interest payments they generate. Although not considered “investment grade,” these bonds rarely go into default, giving you the best of both worlds.

Bond #3: Osterweis Strategic Income Fund

Also on the less-conservative end of the bond market is the Osterweis Strategic Income Fund (OSTIX). In the investment world, “strategic” is really code for “non-investment grade,” so you have to be careful about which funds of this type you own. That’s because the key to running a successful strategic income fund is being intimately familiar with each of the bond issuers you follow, and knowing which ones are going to be able to make full interest and principal payments in the future.

This fund was founded by Osterweis Capital Management and is led by Carl Kaufman. It consists primarily of high-yield bonds currently yielding about 4.6%. The fund is weighted most heavily in industrials, consumer staples, and consumer discretionary sectors, and has a contrarian position on industrials compared to similar funds.

The moral of the story is this: There is much more to the bond market then simply collecting interest and waiting for your bond to mature. Like stocks, bonds fluctuate greatly in value providing an opportunity to capture huge returns without ever stepping foot in the stock market. But because little information about bonds is available publicly, we recommend owning them via diversified and professionally managed mutual funds like the ones identified here.

IMPORTANT NOTES:

Guidance concerning the stocks highlighted in this report is believed to be accurate and represent our best advice at the time of writing. However, market conditions change constantly and guidance at the time of this writing may not reflect our latest advice. For our current take on any stock in this report, it is vitally important that you check the Portfolio tables on the website and confirm that the stock still earns a buy rating. Furthermore, confirm that the stock trades below our current buy limit. Do not buy any stocks above our recommended buy limits. If a stock’s price exceeds our buy limit, wait for a pullback or invest in another Portfolio holding that trades below our buy limit. Any advice in the Portfolio tables, a recent issue of the publication, or our email alerts always trumps older advice in this special report. We reserve the right to substitute special reports as market trends dictate.

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