# UP THE INVESTMENT LADDER
## A Winning Strategy For Investing In Fixed Income Securities

*By Robert D. McHugh, Jr.*

If you ask most brokers whether interest rates are going up or down, invariably the answer will be that they are going down. Brokers are nice people, but they are salesmen, and many -- not all -- will tell you what you need to hear so you'll buy securities. They know you'll be more inclined to invest in notes and bonds if you believe interest rates are at their peak and headed down. Brokers are typically bullish, of course, because they make large amounts of money in bull markets, be that for equities or bonds or any commodity out there, really.

For many fixed income investment portfolio managers, capital gains are the ultimate objective, with double-digit returns highly desirable. To achieve these objectives, portfolio managers buy notes and bonds when they think interest rates are going down, and sell notes and bonds when they think rates are going up – the operative word here being "think." To decide *when* to buy and *when* to sell notes and bonds, investors will often consult with their brokers. The broker's advice 90% of the time? "Buy!"

After a while, the portfolio manager who happily took the advice may start to feel some anxiety. As rates rise and bond prices fall, the value of recently purchased bonds decline. Articles appearing recently in *The Wall Street Journal* suggest that interest rates are likely heading higher. In times like this, the temptation of a portfolio manager is to sell, for surely tomorrow's prices (moving in the inverse direction of interest rates) will be even lower. The broker doesn't try too hard to change the portfolio manager's mind; after all, a trade is a trade.

The long and short of this is that the fixed income portfolio manager probably has bought notes and bonds when prices were high and sold when prices were low – just the opposite of what was desired. When a portfolio overemphasizes gains and returns, with little regard for other reasons for investing, the portfolio quickly evolves into nothing more than a trading account, driven like a boat on the high seas of emotion. Trading volume runs high, because the portfolio is churned frequently, in search of elusive gains. Administering this sort of trading portfolio requires considerable time, and I guarantee you many a sleepless night.

### Objectives of Portfolios

Investors should not look at their portfolios of securities as isolated profit centers. Instead, investment practices should be developed with a mind toward managing risks, meeting contingencies, and optimizing returns. A well-managed investment portfolio should have the following objectives:

(1) To provide a well-diversified portfolio of safe, credit-worthy assets
(2) To offer a dependable and continuous source of cash, and to provide a secondary, indirect source of liquidity (can be pledged as collateral for borrowings, for example)

(3) To manage market value risk
(4) To provide a steady stream of dependable earnings (coupon interest payments)
(5) To provide capital gains opportunities

How can a portfolio accomplish all of these objectives? Aren't liquidity and earnings mutually exclusive goals? For cash liquidity, don't you need to stay short-term – the low end of the earnings curve? And where do you invest to minimize market value fluctuation risk?

Investment portfolio management is as much art as science. I would like to suggest an approach that is nearly perfect for accomplishing all of the above objectives. The approach is fairly simple to understand and to administer, but it requires a great deal of discipline, cash, and works best with an upward sloping yield curve (short term interest yields are lower than longer term yields – which happens to occur the majority of the time). You also have to be willing to stay with the strategy in the face of some early paper losses.

This strategy, **called the ladder approach**, will permit you to choose varying types of securities investments. Thus, if tax management is a concern, you can mix in some municipal notes or bonds. If earnings are a high priority, you may want to choose corporate bonds over U.S. Treasuries or U.S. Agencies. On the other hand, if you have a considerable amount of high-risk assets in your overall financial position, for example equities, then choosing U.S. Treasuries makes sense so you can diversify credit risk.

**Example:** Let's say you have $1 million to invest. The first thing you must ask yourself is how much cash you would need for temporary emergencies. What if you lost your job? You might need a couple of years to find something comparable. So let's say $200,000 is off limits. That leaves $800,000 available for investment.

Next ask yourself how much cash you would like to see coming in (maturing) each month. Let's say you want $20,000 each month. Then you should divide the $800,000 available for investment by $20,000, giving you 40 blocks of investments. You will be making 40 investments of $20,000, each with a different maturity.

Next, you need to make a risk assessment of where we are in the interest rate cycle. Are rates at historic lows, meaning the probability of rates rising, and perhaps rising substantially, is high? If so, we'll want to weight the distribution of maturities toward the shorter terms. Still, there is always the risk that rates could go lower -- perhaps due to an equity market collapse or another terrorist attack – so we'll want to have some longer term maturities in place as well.

You now must determine what types of securities to purchase. If you already hold assets with significant credit risk, perhaps equities that pay no dividends, have no earnings, are start-up technology firms for example, perhaps you own bonds of a firm whose credit ratings keep slipping, or Fannie Mae or Freddie Mac – issues with increasing derivatives risk, and risk of downgrades or default should the economy head south – you will want to choose very low credit-risk issues such as U.S. Treasuries. However, to enhance yield a bit, you also will select some high grade corporates or maybe some municipal general obligation issues.

You map out your security ladder, investing $20,000 in issues maturing in 40 different periods, spread throughout a short to medium term horizon, perhaps from 1 month to 5 years out. To keep the average term at two and a half years for starters, if you purchase a security maturing next month, you may need to purchase another one maturing five years from now. Your portfolio will be skewed toward the short term at the beginning. That way, if market rates rise, you have the chance to reinvest a good portion of your funds at the higher rates.

**How gains climb**: Next month, you will reinvest the maturing $20,000 at the high end of the yield curve, at the 60 month yield of 3.5%. You will be replacing a 1.5% security with a 3.5% security, without changing the overall average term of the portfolio. If this process continues, you will eventually have an entire portfolio if securities yielding an overall 3.5% instead of the current 2.25%, yet the average term will be the same.

In the long run, you will see some nice capital gains in the shorter end of the portfolio, as the 3.5% securities roll down onto the short-term maturity rungs. The long end of the portfolio will realize capital gains during periods of falling interest rates, which is exactly one of your goals. During a rising rate period, liquidity from the longer end of the ladder is not needed, so you can weather normal market depreciation and wait the rising rate cycle out. Worst case, you hold these issues until maturity and cash them in a par. And if you have extraordinary needs for profits, perhaps to offset losses in equities, even in a rising rate period, capital gains should be available in the short-term end of the ladder.

Many wrinkles can be added to this approach. If you end up with 25% gains in the entire portfolio, it may make sense to sell the whole thing, build up cash, and start again, figuring interest rates will rise soon enough that the portfolio's new lower startup yield can be improved within a reasonable period of time. Another option is to purchase an additional quantity of securities because you have extra cash on hand, or to take advantage of specific yield curve opportunities (the curve isn't always rising, often it inverts). Here you simply fill in previously empty slots in the ladder maturities. Or perhaps you want to cash out of bonds because it's time to rebalance all of your assets and increase your position in equities (perhaps equity PE's have fallen to bargain levels, maybe between 6x and 10x on blue chips, with dividend yields floating above 5%).

*You must have patience when starting*. You may initially be underwater if rates start rising just as you begin the investment ladder. But the $20,000 maturing next month can be reinvested at the higher rates. Even if interest rates don't fall soon, time alone, combined with the natural upward slope of the yield curve, will bring the portfolio above water. Gains will appear, yields will be high, and liquidity will be flowing steadily from periodic coupon payments, the reinvestment of coupon payments having a compounding effect on yields.

Refer to the following chart for a sample starting ladder:

**INVESTMENT STARTING LADDER**

| Month Maturing | Security | | Yield | Month Maturing | Security | | Yield |
|---|---|---|---|---|---|---|---|
| 1 | T Note | $20,000 | 1.50% | 31 | T Note | $20,000 | 2.75% |
| 2 | T Note | $20,000 | 1.55% | 32 | | | |
| 3 | T Note | $20,000 | 1.60% | 33 | T Note | $20,000 | 2.80% |
| 4 | T Note | $20,000 | 1.65% | 34 | | | |
| 5 | T Note | $20,000 | 1.70% | 35 | T Note | $20,000 | 2.85% |
| 6 | T Note | $20,000 | 1.75% | 36 | | | |
| 7 | T Note | $20,000 | 1.80% | 37 | T Note | $20,000 | 2.90% |
| 8 | T Note | $20,000 | 1.85% | 38 | | | |
| 9 | T Note | $20,000 | 1.90% | 39 | T Note | $20,000 | 2.95% |
| 10 | T Note | $20,000 | 1.95% | 40 | | | |
| 11 | T Note | $20,000 | 2.00% | 41 | T Note | $20,000 | 3.00% |
| 12 | T Note | $20,000 | 2.05% | 42 | | | |
| 13 | T Note | $20,000 | 2.10% | 43 | T Note | $20,000 | 3.05% |
| 14 | T Note | $20,000 | 2.15% | 44 | | | |
| 15 | T Note | $20,000 | 2.20% | 45 | T Note | $20,000 | 3.10% |
| 16 | T Note | $20,000 | 2.25% | 46 | | | |
| 17 | T Note | $20,000 | 2.30% | 47 | T Note | $20,000 | 3.15% |
| 18 | T Note | $20,000 | 2.35% | 48 | | | |
| 19 | T Note | $20,000 | 2.40% | 49 | T Note | $20,000 | 3.20% |
| 20 | T Note | $20,000 | 2.45% | 50 | | | |
| 21 | T Note | $20,000 | 2.50% | 51 | T Note | $20,000 | 3.25% |
| 22 | | | | 52 | | | |
| 23 | T Note | $20,000 | 2.55% | 53 | T Note | $20,000 | 3.30% |
| 24 | | | | 54 | | | |
| 25 | T Note | $20,000 | 2.60% | 55 | T Note | $20,000 | 3.35% |
| 26 | | | | 56 | | | |
| 27 | T Note | $20,000 | 2.65% | 57 | T Note | $20,000 | 3.40% |
| 28 | | | | 58 | | | |
| 29 | T Note | $20,000 | 2.70% | 59 | T Note | $20,000 | 3.50% |
| 30 | | | | 60 | | | |

I think you'll find this to be a terrific conservative investment strategy during turbulent economic times. Happy investing!

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