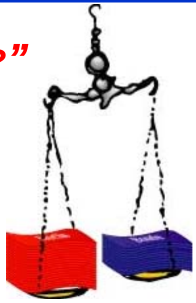
Investment Watch

1st Quarter, 2004

"REBALANCE?"



"***To rebalance or not to rebalance: that is the question.***" (a brazen twist on Shakespeare's soliloquy). Rebalancing requires you to sell the *winners* and buy the *losers.* Last year the *winners* were stocks - stocks of all sizes, styles and types. If you've invested in both stocks and bonds, your stocks are over-weighted, you should rebalance your account and sell some stocks and buy some bonds. Right? Well...

I've always preached that you <u>must</u> be disciplined and rebalance your investments when they get out of kilter. This time however, not only is the mix of stocks and bonds out of kilter, bonds themselves are out of whack! And, herein lies the dilemma — *should you buy bonds when interest rates are so low?*

Any discussion of interest rates begins with **Federal Reserve Chairman**, Alan Greenspan. Sometimes I think Greenspan's equilibrium has suffered with age, but his current balancing act is reminiscent of the Great Houdini! He's keeping a lot of balls in the air. However, his customarily calm, cautious, level-headed delivery has given way to an anxious urgency.

Within 24 hours in February, he chastised Congress over the federal deficit, ticked-off millions of elderly Americans when he suggested immediate action to reduce Social Security benefits, and roiled the mortgage markets by vocalizing the risk posed by Fannie Mae and Freddie Mac! <u>These issues are not new</u>. *Why the urgency? Is this just old-age paranoia or is there a method to Chairman Greenspan's madness?*

Let's seek some sanity by consulting with the **"Bond King"** himself, Bill Gross, who runs the largest bond fund in the world! Bill tends to be conservative and maintains a low profile. Not now! Bill Gross has made the front page of the financial news for his controversial proclamations. First, he stated that he personally had moved all of his money out of his <u>own</u> bond fund to invest in inflation protected investments. The Bond King sells his <u>own</u> bond funds! *The premier bond manager fears inflation more than Greenspan? Yes!*

Next he launched a personal assault comparing Greenspan to Barney Fife, Andy Griffith's bumbling deputy. Even though I can see the resemblance, Bill goes further, asserting that Greenspan has reflated the stock and housing bubbles by lowering the Federal funds rate from 6 1/2% to 1%. Gross deduces that Greenspan has painted himself into a corner and like Barney, doesn't have any bullets loaded in his gun with a 1% Fed rate. A few years ago, Gross thought Greenspan was on target with his "irrational exuberance" theory. But now he believes he foolishly embraced the productivity miracle.

Okay, has everyone gone off the deep end? Personally, I've felt pretty level-headed until I overheard someone say, "if you're calm, cool and collected while everyone else is panicking, you really don't understand the issue!"

So let's talk about ***the issue - interest rates***.

When you invest in bonds, you loan money to a company or to the government. These loans have a <u>coupon</u> and a <u>maturity date</u>. "Coupon" is an old fashioned term used for the interest payment. Bonds used to have coupons attached to them. You would clip the coupon and send it in for your interest payment. *"Clipping coupons" sound familiar?*

For example, Ford Motor is retooling an assembly plant. Ford issues a bond that pays 4% interest for 5 years. You loan them money by purchasing a $1,000 bond. Ford pays you 4% or $40 per year interest and upon maturity in 5 years they return your $1,000 principal.

While you hold your bond, the value is not dependent on Ford's success. But what if just after you buy your bond interest rates jump to 6%? Now Ford must pay 6% or $60 rather than $40 per year for 5 years or $100 more in total. Therefore, your bond goes down in value from $1,000 to $900 (ignoring the time value of money).

Bonds have interest rate risk! Okay, I get it! If interest rates go up bond prices go down. On the other hand, if interest rates go down bond prices go up. The analogy of a teeter-totter is frequently used.

Now let's extend our analysis by changing the maturity of the bond. If the bond is a 10 year bond, we're on the hook for twice as long. Therefore, if interest rates go up our loss is twice as much. Alternatively, if the maturity is short, a change in interest rates will not effect our bond value as much.

The <u>length of maturity</u> of a bond determines it's relative **risk** to interest rate fluctuations. Bond maturities are termed (no pun intended) short-term, intermediate and long-term, 1-3 years, 4-9 years, 10 or more, respectively. **The longer the maturity the more price volatility or interest rate risk.** A money market fund is actually just a very short-term bond fund (less than 1 year maturity) that is virtually unaffected by interest rates fluctuations.

So why has everyone gone berserk? Because everyone believes that our *historically low, 40-year low,* interest rates will go up. Why will interest rates go up? Everyone thinks that -

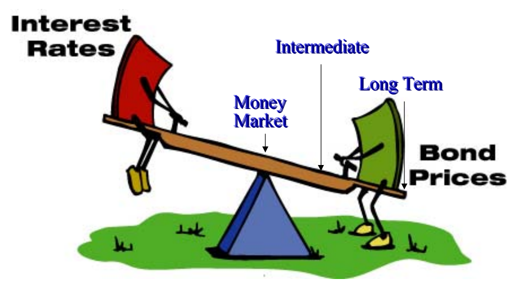
- the trade and budget deficits will trigger higher inflation. Inflation results in higher interest rates.
- Greenspan will begin raising the Fed fund rate which will trigger increases in other interest rates.
- the US dollar's decline will require higher interest rates to attract foreign investment. We need foreign money to fund our excesses.
- **when interest rates go up, bond prices will go down.**

With this as a backdrop, last quarter's inexplicable <u>decline</u> in interest rates and the significant <u>drop</u> in core inflation propelled bond prices upward. Are Greenspan's global fusion and productivity miracles materializing? Are we riding the ***Economic Nirvana*** wave? Maybe, but it can't last forever.

Our economy is strong with estimated GDP at 4.2% for the first quarter. Productivity gains due to technology and global integration are still running high. However, the strength in our economy and the soaring budget deficits will eventually rekindle inflation. We all know Greenspan's darkest enemy is still inflation. He will need to raise the Fed funds rates early next year and interest rates will follow.

What should we do? First, should we rebalance between stocks and bonds? I believe that longer-term bonds are just as risky as stocks these days. If stocks are not more risky, keep your current allocation **weighted a little more toward stocks**. You might reap the generally higher returns of stocks without the increased risk level.

If you're too disciplined and must rebalance, rebalance into bonds but **shorten your maturities.** Even if your stocks are not out of kilter, shortening the length of maturity of your bonds will make them less sensitive to interest changes.



Difficult decisions. Difficult subject matter. Two last thoughts, "When your horse dies, it's time to dismount. When you come to a fork in the road, take it." Shakespeare was classical but Yogi Berra was a classic!

Keith Kowalczyk

The 401K store.com

4940 Washington Avenue
St. Louis, MO 63108
(314) 367-6555