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Newsletter Q4 2018

The World is Flat – for Bonds

We have prepared this early addition of our newsletter because of all the recent movements and discussions on interest rates and how it affects our client's investments.

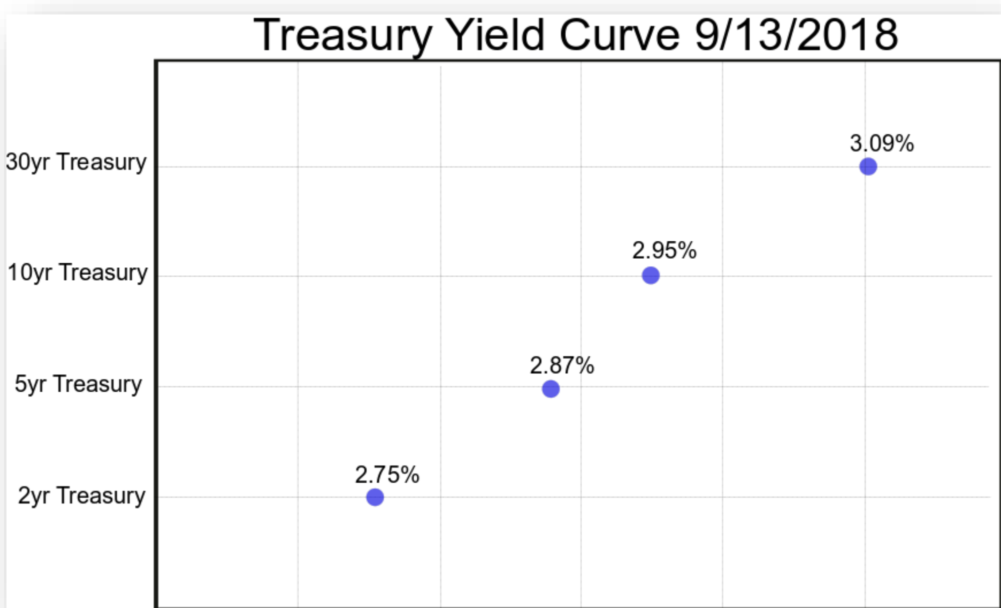
What is a Flat Yield Curve and Why does it Matter?

A normal yield curve is very simple and something everyone can relate to - you get a higher interest rate for loaning longer term. Very natural to expect more return for 30 years, than for 5 years.

A flat yield curve still pays more for loaning longer term, but the incremental amount is negligible. The chart reflects current yields on US Treasuries (subject to change). In the chart a 2yr has a 2.75% yield, a 10yr equals a 2.95% yield and a 30yr pays 3.09%.

Another way of analyzing is in dollar terms for a $100,000 investment;

A 2yr pays $2,750 a year in interest, and the 30yr pays $3,090.



The question we face daily as portfolio managers is to assess such decisions. What is best for our client portfolios based on current market conditions and the forward trend?

If we thought rates would decrease significantly then higher yield longer-term bonds look favorable. The opposite would be true if we thought rates were going to dramatically rise. We look at the bond

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market each day and search the Schwab bond inventory constantly for investments that we believe are smart for our client portfolios on a risk-adjusted basis.

Charles Schwab (our custodian) and how we buy bonds from them.

When I worked in private wealth management at Smith Barney and UBS Financial, these firms purchased their own bond inventory and advisers could show them for client purchases. These organizations marked up their price from what they purchased, and the bond desk worked as its own profit center. Charles Schwab works differently, as they have a national inventory and pass through other dealers' offerings, so the adviser gets a large selection to choose from. There are also efficiencies in the buying process as we I see the bids and offers from many dealers' inventory. Added efficiencies occur when we make a bulk purchase of a bond as we can sometimes negotiate a better price versus listed. We use our custom computer program to allocate to our clients. This allocation sometimes includes a client only buying 2-3 bonds in a portfolio and our process can make this purchase efficient and seamless.

We have had numerous discussions with clients recently regarding bond allocations in their portfolio and we are always available for any client question or concern on fixed income investing.

I have been saying for years that clients should consider keeping cash and short-term liquidity but with recent rate changes and the state of the fixed income market we have been busy as bond buyers. For clients that need high-quality safety and liquidity we strongly suggest the use of FDIC insured Certificate of Deposits (CD's). We are extremely proud to be able to offer our clients a zero commission and zero management fee for all CD's. The current range for 3-4 months CD's is 1.5-2% (subject to change).

The Cost of Waiting.

There is a math formula that accounts for the present cash flow you receive by purchasing a bond at todays rates and then comparing how you would have done if you waited a year for rates to increase. This analytical assessment is not based on bond quality, but just the math of getting paid now versus waiting. As we have analyzed we believe the best "Bang for the Buck" is in bonds with maturities in the 2-7 year range so that is what we have been searching for client portfolios.

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