Beware of Good Yields (Continued)

The second (recent) lesson was reinvestment risk. Throughout the 1980's, savers were told by investment professionals that CD's were riskless, only to find interest rates on CD's dropping from 8% to 3%. The third (recent) lesson is that international money market funds have currency risk. Since September 1992, many investors in International Money Market Funds have seen their principal shrink by 15-20%. We believe that the public is about to learn about the risk of "callability" on corporate and municipal bonds and on corporate preferred stocks. Last time, the primary risk on most corporate high yield securities was corporate bankruptcy. Such securities were issued by companies with weak balance sheets at a time when the Federal Reserve was squeezing and the economy was slowing down, making bankruptcy more likely. Today, bankruptcy risk among the issuers of high yield securities is lower for four reasons:

1. The Fed is expanding the money supply,
2. The economy is expanding,
3. Lower interest rates benefit big borrowers the most, and
4. Investors and underwriters are very sensitive to the risk of bankruptcy.

But the decline in interest rates which have lessened bankruptcy risk has increased the number of bonds selling at premium prices and the risk of callability. The accompanying table is a small section of a table which appears in the Wall Street Journal every day under the heading of "Treasury Bonds, Notes & Bills." The table lists the Treasury Bonds currently outstanding along with the latest Bid and Asked Prices. The final column gives the yield-to-maturity based on the Asked Price. The yield-to-maturity is the total return (annualized) if the bond were bought today at the Asked Price and held to maturity. Thus, if you buy a 7 1/4% U.S. Treasury which matures in May 2016, you can expect to pay 104 cents on the dollar. From now to May 2016, you will receive interest payments of $7.25 per hundred (7 1/4%)each year; and in May 2016, you will receive the bond principal of 100 cents on the dollar. Therefore, you will have a guaranteed loss of 4 cents on the dollar of principal. The final column shows that although the interest payment is 7 1/4%, once you adjust for the loss of principal the annualized yield-to-maturity on the Asked Price is 6.82%.

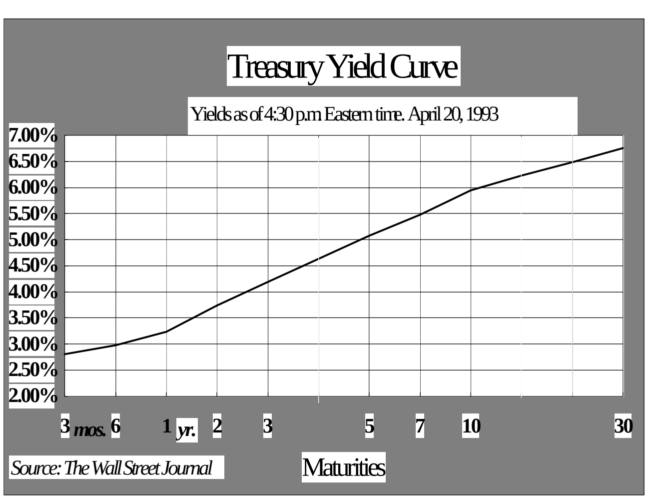
Treasury Bonds, Notes & Bills

Rate	Maturity Mo/Yr	Bid	Asked	Chg.	Ask Yld.
11 1/4	Feb 15	151:01	151:03	-11	6.74
10 5/8	Aug 15	144:03	144:05	- 9	6.76
9 7/8	Nov 15	135:13	135:15	-11	6.78
9 1/4	Feb 16	128:06	128:08	- 8	6.80
7 1/4	May 16	104:28	104:30	- 9	6.82

Most of us wouldn't worry too much about losing 4% of principal over 23 years; but let's look at the 11 1/4% Treasury Bond of February 2015. To get a $11.25 interest payment each year would cost 151 cents on the dollar. Thus, we would receive a current yield of $11.25/151=7.5%; but when the bond matures in February 2015, we won't receive the 151 cent cost. We will only receive the 100 cent par value -- for a lost of principal of 51 cents guaranteed. The final column shows that although the interest payment is 11.25%, once you adjust for paying 151% of par and losing that principal, the annualized yield-to-maturity on the Asked Price is 6.86%. In effect, the market price of the two bonds has been adjusted so that the expected return on the 7 1/4% and the 11 1/4% bonds are nearly the same. If you scan the full table, you will see that, with a few special exceptions, the market has adjusted prices of all Treasury Bonds so that the yield-to-maturity numbers are merely a function of time-to maturity.

Once you consider non-Treasury fixed income securities, you find a further complication because most corporate and municipal bonds and corporate preferred stocks are callable. This means that, just as you and I can pay off or refinance our home mortgages when we choose to do so - with little or no penalty, corporations and municipalities can payoff (or "call" in) their bonds or preferreds when they choose to do so.

The following is a recent example which crossed my desk. In 1990, a local company, in need of equity capital, marketed a preferred stock to the public. The preferred paid an annual dividend of $2.60 and the stock was sold at $25 for a yield of 10.4% - sounds good - right? It is good enough that since 1990, the market price of the preferred has been bid up to $29 1/2. (Note that at 29 1/2, the current yield on this preferred is $2.60/29.5=8.8%. Still good - right?) Yes, but if you read the prospectus on this preferred stock, you learn that the company can "call" it back in 1995 @ $26.30/share. Should the company not "call" in this preferred, it's annual cost will be 9.4%. Thus, if today's rates hold, it is likely the company will "call" in this preferred issue, and the current holder will lose 11% in principal ($29.50 to $26.30) in the next two years. When combined with the dividends received over these two years, the investor's "yield-to-call" or total return over that two years is 3.5% / year -- which is to say the return is comparable to other securities maturing in two years.



The accompanying "Treasury Yield Curve" is also printed in the Wall Street Journal every day. It is simply a plot of the Yield-to-Maturity rate from the table "Treasury Bonds, Notes & Bills" excerpted earlier. As a rule of thumb, if any security seems to provide a yield more than 1% above this curve (at the appropriate time span) - there is a risk that you haven't been told about.
Be careful out there!

As you have noticed from our letterhead, we have recently installed an 800 number for our clients living outside the Pittsburgh area. We are also utilizing a voice mail system to improve our ability to communicate with everyone interested in talking to us. Let us know if these are useful tools and if they can be improved upon. As always we welcome your calls and letters.