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CHAPTER 1

Portfolio Survival

Richard Lancaster ran a shaking hand through his silver hair. "What do you mean my 401(k) is worth only half of what it was last year?" he screeched at his Smith & Co. broker. "That was my retirement money."

Lancaster is an aerospace engineer living and working in Redondo Beach, CA. He is 60 years old and was hoping to retire in three years. At least he and wife, Ruth, own their home. And the kids have moved away and are self-sufficient.

"We needed every cent of that $2 million to generate income to live on," cried Lancaster. "Why didn't you tell me things were dicey? I would have sold out a year ago. Weren't you minding the store like you promised?"

That was Lancaster's first mistake: Putting his entire 401(k) account in the hands of a single stockbroker. What the broker hasn't told him yet is that he put half the portfolio in the corporate bond market. He figured it was safe enough for the old guy. It didn't generate much commission, but he fixed that on the front end by hugely marking up the bonds when he sold them into Lancaster's account from the firm's own inventory. Problem is, the value of those bonds has fallen just as much as the stocks. For some, he can't even get a bid from the broker who sold them in the first place.

It looks like Richard Lancaster will be working for the foreseeable future. His case isn't uncommon. If this hasn't happened to you, you probably know someone to whom it has. The good news is that you can do something about it so you don't become another casualty of the bond market.

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Too many investors had their bond portfolios on cruise control throughout the 2008/2009 credit crisis. The result: Their portfolio values shrank by a third or more. We've heard way too many of these middle-aged and older investors shrug their shoulders, saying, "I'm in good company. Everyone has suffered a downturn in portfolio value. There was nothing anyone could do about it."

We call that stinkin' thinkin'. Certainly, few saw America's economic collapse coming. Wall Street and the rest of the professional investment community sure didn't. How could they? Such a collapse hadn't happened in their lifetime. That's half excusable. What isn't excusable is that so many individual investors are doing nothing about it. They think that if they stick to their old bond investment strategies and use the same hackneyed brokers they always have, somehow things will get better. They won't. The bond market targets such people and takes their money like a thief in the night.

Then there are the seasoned investors who understand that things have changed. Structurally changed. Some employ a new strategy when buying bonds for their retirement portfolios. Perhaps they got religion and now look at the underlying bond ratings rather than the rating of the unstable bond insurer. However, too few have applied this discipline to their *existing* bond portfolio. That's where the real risk lies. That's also where their emotional favorites reside. Many view these as untouchable. See the fallacy of their mistake? Read on.

Moody's Investor Services, one of the Big Three bond rating agencies, recently assigned its "negative outlook" to the creditworthiness of *all* the nation's local governments. This has never been done before. It should serve as fair warning to bond investors. Unless individual investors press the restart button on their investment strategies, their principal will continue eroding. Pretty soon they won't have enough money generating sufficient income on which to live. They will be forced to live on a lower economic level than they ever thought they would. Visualize a retirement without the ability to go to restaurants, take the trips you dreamed of, and buy gifts for the grandkids. Doesn't look very appealing, does it. All because many refused to change their investment habits, to employ a new strategy specifically designed to cope with and profit from the challenging economic environment in which we find ourselves. In other words, *to press the restart button for portfolio survival.*

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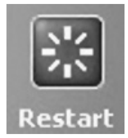

No More Cruise Control

At one time in the not-too-distant-past—2008, in fact—fixed income investors could buy a municipal bond without much worry. They could put bonds in their securities portfolio and forget about them. Many counted their bond portfolio as their core nest egg—their safe money. They were on cruise control.

Bail out was something you did for fun from an airplane with a parachute. “Sure,” they said, “municipalities have their problems. But they aren’t in danger of imminent default on their bonds, are they?” Yes, some are. We’ll show you how to spot them. Read on.

What Went Wrong in Bondland?

Lots. First came the problems with corporate bonds. During 2008, when the credit crisis reached critical mass, the spread between corporate bond yields versus those of Treasuries swelled to historic levels. This signaled the flight to quality as investors traded riskier corporates for more stable Treasuries. Investment-grade corporate bond prices began falling and didn’t stop until they bottomed near the levels of junk bonds from just one year earlier. Then came a panic sell-off by the hedge funds. The hedgies had to meet insistent margin calls. They were selling stocks, bonds, real estate—anything not nailed down.

With these emergency margin calls came the first cries for bailout America. They came from those institutions that thought they were too large to fail. The TARP money given to banks was supposed to

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be their salvation. It wasn't. Instead it shackled management teams and prevented them from making the decisions needed to run their businesses without first asking the government's permission.

Government interventions—some call it the first steps toward nationalization—have changed the entire investment landscape. Individuals who ignore this change and who refuse to alter their investment strategies will pay the price.

Action Step: Avoid Industries with Government Intervention

Never buy a corporate bond with even a hint of government participation, curiosity, or investment. Knowing what not to buy is often just as important as knowing what to buy. The Action Steps sprinkled throughout this book will tell you what to look for.

Municipal Bond Problems

Soon the corporate evils gravitated to the municipalities. We saw a symptom of the dilemma facing state and local bonds when five governors requested that the federal government provide $1 trillion in economic stimulus money—a mammoth bailout.

The five governors were John Corzine of New Jersey, David Patterson of New York, Deval Patrick of Massachusetts, Ted Strickland of Ohio, and James Doyle of Wisconsin. Take special note if you own bonds issued by these states. In fact, these funds were supposed to fill in their own state's budget gaps but couldn't easily get the job done.

As if that trillion-dollar number wasn't scary enough, these governors wouldn't come to terms with the spending cuts needed to ensure we taxpayers don't have to bail them out a second or third time. Excessive leverage caused the 2008 financial implosion. That, and enterprises thought too big to fail were living beyond their means, then crying for a bailout when their capital dwindled to perilous levels and they couldn't pay their bills. That now infamous word, bailout, has recently entered our every day lexicon. It forces us to accept the results of what we've allowed to happen.

We don't have to drill down much deeper to connect these events to municipal bonds. Our states and cities cannot borrow their way out of these self-created deficits. Further adding to bondholder's

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travails is that five of the twelve largest municipal bond underwriters and trading desks have merged or exited the business entirely. This means that now there are fewer execution resources available to bond investors. And there is less capital being allocated to municipal bond inventories.

Essential Liquidity

Without an adequate number of institutions to execute bond trades, liquidity is sucked right out of the market. Without liquidity, investors are at the mercy of only a few bond dealers who can name whatever price they wish. Watch for the concept of liquidity. We'll pound on it throughout this book.

Liquidity in Bondland means having sufficient buyers and sellers for a particular issue to maintain an orderly, arms-length market that is driven by price, yield, spread, and supply and demand rather than a single participant with the ability to control the market.

Liquidity has several components. First is the number of underwriters, issuers, and dealers. Investors must be able to play one bond source off the others. If the price of one broker/dealer is off the market, his competition will likely offer it at a better price. Another source of liquidity is the size of the issue. Bond investors—the savvy ones, at least—only buy corporate bond issues with a minimum size of $250 million. Such size prevents a single investor from capturing the majority of the issue. If you hold a few bonds in a thinly traded issue, you'll rarely get a fair price. That is, if you can scare up any bids at all.

You may ask, "What about my bond fund? Risk is spread over a whole trainload of different bonds. Surely such diversity provides safety." Untrue. In the credit crisis, municipal and corporate bond funds had massive outflows. Funds without sufficient cash to honor investor demands for their money were forced to sell assets (bonds held in their portfolios). The Street smelled blood in the water. The funds were forced to take what they could get for their assets. Fund prices plunged. Panic set in. Investors tripped over one another, seeking the safety and security of Treasuries. This drove T-bills to a negative rate of return.

Bond Downgrades

We've dedicated Chapter 7 to the rating agencies. Watch for them to downgrade more bonds. This is due to the municipal bond issuers'—the states, cities, and school districts—overreliance on property tax revenues amid the bear market in housing. Property taxes account for 72 percent of local government income throughout the nation. The steep decline in property values caused these same governmental entities to suffer a huge revenue shortfall. As revenues fall, so does the likelihood that the issuer can maintain its debt service on the bonds it issued. The less coverage of debt obligations a bond issuer has, the lower its bond rating. The cities and counties spent money as if property values would never decline. They suffered dearly when housing values plummeted like that blue ice that sometimes falls off of airliners and comes crashing to earth.

As the inevitable happened and property tax revenue began shrinking, many municipalities could not stop the spending. They dug an even bigger hole by issuing revenue and tax anticipation notes to bridge the cash flow gap that their dwindling reserves should have covered.

These tax anticipation notes are supposed to be a temporary, short-term way of managing cash flow. As property tax revenues rise again and are collected, part of the money is used to repay the tax anticipation notes. The problem is, not only are property tax revenues not rising, but also the rest of the massive budget deficit is laying claim to the same money—that is, when it's finally collected. Suddenly, muni bondholders see their formerly safe investments as being subject to unprecedented risk. Who knew? We did. Now you do, too. No more excuses. No more tears. Let's get busy fixing the problem.

Also in Chapter 7, The Bond Rating Agencies, we will cover the massive amount of corporate bond defaults and downgrades post credit crisis. Fallen Angels, that's the sweet, peaceful phrase that Wall Street calls investment grade bonds that fall into the junk bond category. Historically, when an investment-grade corporate bond becomes junk, it's a very long, arduous climb back up to the promised land of investment grade.

Pushing the Restart Button

This book is all about new bond market survival rules and strategies. The landscape has changed. So must your bond investment strategy. Use the new market rules found here to your advantage and not only will you survive, but you'll thrive.

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The New Bond Strategies

Even the savviest investors have had to change. The rules are being rewritten even as regulatory guidelines remain in flux. You may have invested the same way for decades. Now you must change. You may look at your decimated portfolio and say, "It's only an aberration—a long and deep one—but still just an aberration. Things will get back to normal any day now." It's not an aberration, and many things will never be the same again. The strategies of fixed income investing have changed forever.

Bond Insurance—Fageddaboudit

Buy only good quality municipal and corporate bonds that can weather the economic downturn on their own without depending on bond insurance. Buy bonds whose own ratings justify your confidence and investment dollars.

There are bond ratings, and then there are bond ratings. Be sure you know what you're looking at. The Big Three bond rating agencies (Moody's, Standard and Poor's, and Fitch) now assign two ratings to many municipal bonds. One has to do with the default insurance a particular issue may have. The other is the credit quality on the municipal bonds as a stand-alone—the underlying rating. If a bond is insured by a stable insurer such as Berkshire Hathaway Assurance that carries a Moody's rating of Aa1 and a Standard & Poor's rating of AAA, then chances are the underlying credit quality of the municipal bond is a minimum of A rated. The municipal bond insurers, both past and present, insured for a zero default rate. That was before so many municipalities hit the wall and suffered cash shortfalls.

However, if a bond is insured by a suspect firm such as National-Re (formerly MBIA Insurance Corp.), to which Moody's assigned Baa1 and Standard & Poor's assigned AA– ratings, then there's more to the story. Most of the bond insurers have problems. Many have had their ratings withdrawn entirely or have been placed on the rating agency's negative watch lists.

Note that the credit crisis and bear market in stocks have even taken their toll on the mighty Berkshire Hathaway. Stripped of its AAA rating, Moody's has dropped Berkshire's ratings to Aa1. Still a superior rating, but one notch lower than it was. Moody's cited the decline in equities, derivatives, and the economic downturn as the primary reasons for the downgrade. Even the vaunted Berkshire

Hathaway now has a chink in its armor. Understand that all ratings change over time. By the time you read this, they will have changed again.

There's real concern about bond issuer defaults. The insurance companies do not have sufficient reserves to make good on all those shaky bond deals they insured. When the avalanche of defaults occurs, they may be unable to pay everyone they owe. In other words, their insurance isn't worth much. So goes the bond's rating, which directly reflects the insurance company's rating.

It only took the bond insurers a few years to destroy their business. They accomplished this by insuring collateralized debt obligations (CDOs) and shaky mortgage-backed securities.

Underlying Credit Rating: The Real Test

The rating agencies are historically slow to change their ratings for fear of stepping on the toes of those who pay them. The result is that you must look at the *underlying* rating, that is, a rating that considers just the creditworthiness of the issuer *without regard* to the insurance.

Corporate bond defaults are not that uncommon. According to *Forbes* newsletters, over 200 corporate bond issues totaling some \$20 to \$50 billion default in a typical year. In addition, there are 300 to 400 corporate bond defaults and bankruptcies that remain unsettled. Expect that number to increase over the next few years. Recession reduces the value of corporate assets. Those remaining banks that can lend money will refuse to do so for fear of further compromising their already damaged balance sheets. The government's TARP money helps only a little, since some of the banks are doing absolutely everything they can to repay money that many didn't want or need in the first place.

Action Step: Match Your Bonds with Your Risk Tolerance

Invest in a bond only if the *underlying rating* meets your risk criteria. Likewise for the bonds already in your portfolio. Don't keep any bonds whose underlying rating fails to meet your tolerance for risk. Sell and replace them with more stable bonds. See Chapter 7, The Bond Rating Agencies, for a table showing the meaning of the bond rating system.

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The Safest Municipal Bond Categories

There are just seven bond categories we consider absolutely safe. Our criteria for safety revolve around two things: The bond's repayment source and who pays the bondholders in the event the issuer cannot. Here are the seven safest municipal bond categories.

Prerefunded Bonds

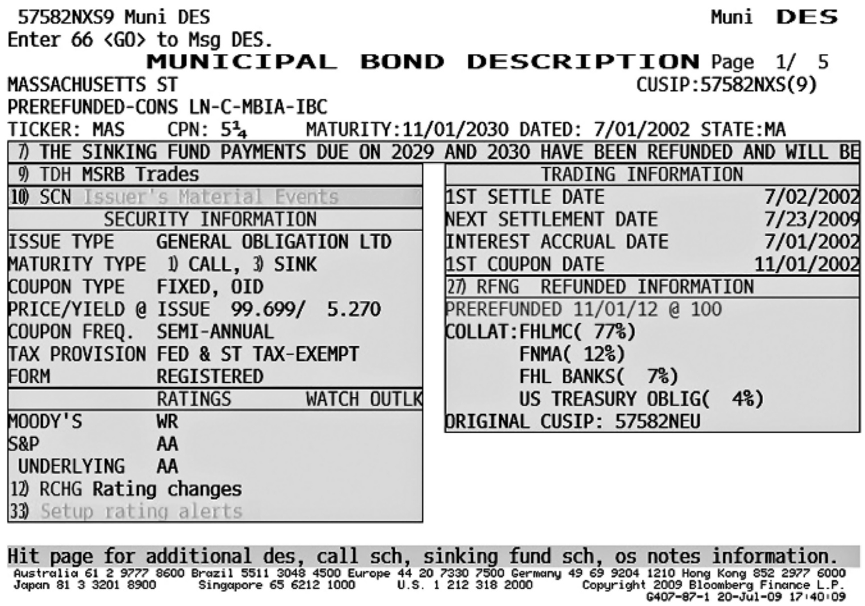
Bonds that were issued some time ago carried higher coupons than the current market. That's why municipalities issue new bonds at lower coupon rates to replace the old bonds. It's a simple refinancing. The municipality invests the proceeds to cover the principal and interest. Essentially, the bonds are refunded (or refinanced) in advance of either the next call date or the maturity—prerefunded or preres in bond vernacular. Investors who buy these prerefunded bonds are guaranteed prompt payment of their interest and principal because the funds are escrowed with an independent institution until they mature and are repaid.

There is a risk—but only to those investors who are unwary or unobservant. The collateral used in the escrow account must be money good. Before you buy a prerefunded bond or one that is escrowed until maturity, make sure the collateral is a SLGS (State and Local Government Series security, pronounced *Slug*). These are special Treasuries with yields that are custom-cut to match those of the old bond issue being replaced. SLGS are used exclusively in escrow accounts. They cannot be traded and are therefore sold directly to the escrow accounts by the U.S. Treasury.

Do not accept a prerefunded bond whose escrow collateral is a Fannie Mae or Freddie Mac security. The federal government has not given its explicit guarantee to Freddie Mac or Fannie Mae—they've only given an *effective* guarantee. That's not good enough. Figures 1.1 and 1.2 show what the Freddie and Fannie collateral looks like on a Bloomberg page.

General Obligation Bonds (GOs)

Most bond professionals consider General Obligation bonds among the safest of the fixed income instruments. GOs have the ability to tap additional tax revenues in the event of an economic shortfall. Since the taxing agencies have the (theoretical) authority for unlimited taxation to pay their bills, the GOs should be money good regardless



57582NXS9 Muni DES — Muni DES
Enter 66 <GO> to Msg DES.
MUNICIPAL BOND DESCRIPTION Page 1/ 5
MASSACHUSETTS ST — CUSIP:57582NXS(9)
PREREFUNDED-CONS LN-C-MBIA-IBC
TICKER: MAS CPN: 5¼ MATURITY:11/01/2030 DATED: 7/01/2002 STATE:MA
7) THE SINKING FUND PAYMENTS DUE ON 2029 AND 2030 HAVE BEEN REFUNDED AND WILL BE
9) TDH MSRB Trades
10) SCN Issuer's Material Events

SECURITY INFORMATION
ISSUE TYPE GENERAL OBLIGATION LTD
MATURITY TYPE 1) CALL, 3) SINK
COUPON TYPE FIXED, OID
PRICE/YIELD @ ISSUE 99.699/ 5.270
COUPON FREQ. SEMI-ANNUAL
TAX PROVISION FED & ST TAX-EXEMPT
FORM REGISTERED

RATINGS WATCH OUTLK
MOODY'S WR
S&P AA
UNDERLYING AA
12) RCHG Rating changes
33) Setup rating alerts

TRADING INFORMATION
1ST SETTLE DATE 7/02/2002
NEXT SETTLEMENT DATE 7/23/2009
INTEREST ACCRUAL DATE 7/01/2002
1ST COUPON DATE 11/01/2002
27) RFNG REFUNDED INFORMATION
PREREFUNDED 11/01/12 @ 100
COLLAT:FHLMC(77%)
FNMA(12%)
FHL BANKS(7%)
US TREASURY OBLIG(4%)
ORIGINAL CUSIP: 57582NEU

Hit page for additional des, call sch, sinking fund sch, os notes information.
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2009 Bloomberg Finance L.P.
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Figure 1.1 Avoid Fannie & Freddie Used as Collateral—Agency Prere

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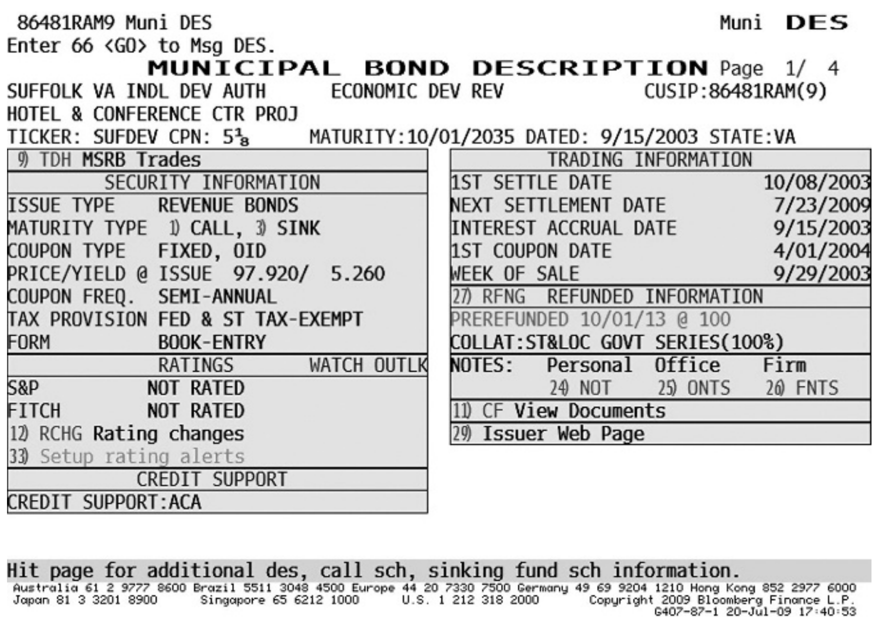

86481RAM9 Muni DES — Muni DES
Enter 66 <GO> to Msg DES.
MUNICIPAL BOND DESCRIPTION Page 1/ 4
SUFFOLK VA INDL DEV AUTH ECONOMIC DEV REV — CUSIP:86481RAM(9)
HOTEL & CONFERENCE CTR PROJ
TICKER: SUFDEV CPN: 5⅛ MATURITY:10/01/2035 DATED: 9/15/2003 STATE:VA
9) TDH MSRB Trades

SECURITY INFORMATION
ISSUE TYPE REVENUE BONDS
MATURITY TYPE 1) CALL, 3) SINK
COUPON TYPE FIXED, OID
PRICE/YIELD @ ISSUE 97.920/ 5.260
COUPON FREQ. SEMI-ANNUAL
TAX PROVISION FED & ST TAX-EXEMPT
FORM BOOK-ENTRY

RATINGS WATCH OUTLK
S&P NOT RATED
FITCH NOT RATED
12) RCHG Rating changes
33) Setup rating alerts

CREDIT SUPPORT
CREDIT SUPPORT:ACA

TRADING INFORMATION
1ST SETTLE DATE 10/08/2003
NEXT SETTLEMENT DATE 7/23/2009
INTEREST ACCRUAL DATE 9/15/2003
1ST COUPON DATE 4/01/2004
WEEK OF SALE 9/29/2003
27) RFNG REFUNDED INFORMATION
PREREFUNDED 10/01/13 @ 100
COLLAT:ST&LOC GOVT SERIES(100%)
NOTES: Personal Office Firm
24) NOT 25) ONTS 26) FNTS
11) CF View Documents
29) Issuer Web Page

Hit page for additional des, call sch, sinking fund sch information.
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2009 Bloomberg Finance L.P.
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Figure 1.2 Instead Accept SLGS as Prerefunded Collateral

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of the economy. Further, GOs usually stand in front of most other bonds. Except, of course, in California. There, the school bonds have first claim on tax revenues, followed by the GOs. Your state may have a constitutional amendment like California's regarding priority of payments. Find out where you stand in the repayment line.

Revenue Bonds with a Secondary Repayment Source

The industry fondly calls such revenue bonds *double-barreled tax exempts*. These munis are a hybrid general obligation bond. However, they're safer than ordinary GOs because the sources of repayment are guaranteed by two separate and distinct revenue streams. Only the *full faith and creditworthiness* of the issuing state or municipality backs regular general obligation bonds. Double-barreled bonds have this same guarantee along with an alternative source of repayment revenue. In the event that one of the revenue streams is compromised (such as the revenue shortfall from sales tax declines), investors still have the security provided by the alternative source of funds. A double-barreled sewer revenue bond is a good example. Such a bond is primarily funded by revenue from the sewer it built, and it is backstopped by the local tax revenues if there's a problem.

Because of the dual source of repayment, double-barreled bonds are safer than regular general obligation bonds. With municipalities struggling and default rates rising, a double repayment source is a big plus.

Double-barreled bonds are hard to find. When you do find them, they may be priced a little higher than other general obligation bonds. You may have to pay for the added safety.

One of the largest double-barreled issuers is the California Economic Recovery. These bonds are backed by a special one-quarter cent pledge to California's sales tax revenues. Then, if needed, they are further backed by the full faith and credit of California. Even though California's economic problems (a $26 billion budget deficit as of this writing) probably won't go away anytime soon, an alternative source of payment reassures investors and makes the bonds more marketable.

Essential Service Revenue Bonds

These are revenue bonds issued for really important infrastructure projects such as the sewers and water facilities. Because revenue from

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property owners who use these facilities repays these bonds, they're generally considered low risk. However, be sure that the issuer is a stable, mature area where property taxes are consistent. Do not buy water and sewer bonds from an issuer that is new and depends on attracting new residents to a new housing development. Further, stay away from issuers whose tax base is eroding because people are being foreclosed with no new owners in sight.

First Mortgage Bonds

First Mortgage bonds are issued by corporations. They give investors the first lien on specific property owned by the issuing corporation. In the event of default, First Mortgage bondholders have the right to seize company property and equipment in order to secure repayment. Seizing and selling property on behalf of bondholders rarely is necessary (and would always be handled by the bond's trustees). More often, the company reorganizes and arranges payment for the bondholders, since the lien gives it no choice but to satisfy the claims.

First Mortgage bonds provide investors an extra safeguard if bankruptcy occurs. In a rising default environment, they're a good safety net. They also earn a decent yield.

However, there's some downside. Because the debt is more secure, the yield isn't always as high as unsecured debt. Remember, there's a rate for every risk. Even so, the yields are still attractive for such a low risk investment, and are certainly higher than alternatives like Treasuries.

Senior Secured Bonds

As with mortgage bonds, the pledge of specific assets as collateral, back senior secured bonds. This means that in the event of default and bankruptcy, bondholders can seize the collateral assets. The best secured bonds employ assets held in a third party trust as their collateral. This could be real estate mortgages as seen above or equipment trust certificates.

The problem with secured bonds is maintaining the assets in a salable condition while bondholders await their liquidation and disposition of the proceeds. Usually bondholders lack the expertise and ability to either maintain or sell the underlying assets.

Senior secured bonds with underlying assets as collateral increase the safety but in practice don't really do much for aggrieved investors.

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We still hope that the issuer does not default on its interest and principal payments. Time is much better spent analyzing the issuer's ability to service its bond debt rather than the value of the secured assets offered as collateral.

Unsecured Bonds

Not far behind the safety curve are unsecured bonds. These depend on the issuer's ability to pay interest and principal. They are backed by nothing more than faith in the issuer's promise to pay. Should the issuer become bankrupt, seniority is an issue. First, the banks get paid. Next come the senior bonds—secured, then unsecured—which get first dibs on whatever is left, after attorney's fees, of course.

Action Step: Steer Clear of Sub-Debt

Don't buy bank-subordinated debt (such as Citigroup subordinated bonds). The government demanded conversion of all preferred shares into common stock. This had the effect of moving the preferred stock holders from near the top of the payment ladder to the very bottom. In no way were the preferred shares ever contractually convertible into common stock. The bond market reaction to such an unprecedented governmental action in a non-Communist country was swift and painful: Citigroup subordinated debt and all bank subordinated debt traded at significantly wider spreads to Treasuries and senior debt than ever before. Bond prices dropped like a rock. Investors worried that if the government can do that to preferred shareholders, subordinated debt may be next.

Warning: Avoid Interest Rate Swaps

Municipalities use interest rate swaps in an attempt to lower municipal bond interest costs. The most frequently used swaps locked in fixed borrowing costs on variable rate debt. As the floor fell out of the interest rate market, local municipalities were horrified to find their bond interest payments tripled or quadrupled due to these toxic swaps. Many small municipalities received cash up front for these deals. They thought it was manna from heaven and spent the money. In fact, it was a deal with the devil.

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You need look no further for the reason Jefferson County, Alabama, the schools in Philadelphia, the City of Detroit, and local California governments to see the disaster created by interest rate swaps. Each is all but bankrupt as a result of the interest rate swap contracts it did.

Why should you care? Because lurking in your portfolio may be a municipal bond with one or several interest rate swap contracts attached. If rates go against these issuing municipalities, their ability to service the debt—debt that you own—will be in serious jeopardy. Call your broker and demand an analysis of each muni in your account. Have him study the most recent Moody's or Standard & Poor's reports. There's almost always a discussion section about interest rate swaps if any exist with that bond. If your broker complains about the work involved, get a new broker. This is important to your financial survival.

These are just the first few new rules of engagement for bond investing. Know them. Follow them. Chapter 2 shows you how to employ them to your advantage.