Chutes and Ladders

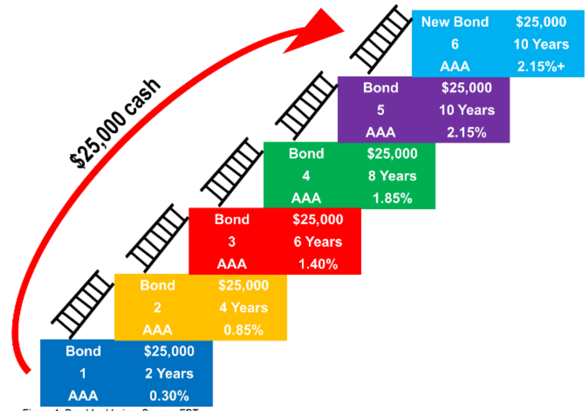

Figure 1: Bond Laddering. Source: FBT.

Bond Laddering is a term with which you may be familiar, and is a relatively straightforward process as illustrated in the nearby Figure 1. For example, let's say that Barry Bond has purchased $25,000 each of five different bonds that come due at regular intervals (2, 4, 6, 8, and 10 years). After two years when Bond #1 matures, Barry has two options. He can 1) Reinvest the principal by "climbing the ladder" to a new 10-year bond, or 2) Take the money out of the ladder to spend or invest elsewhere.

As we will discuss in greater detail throughout this article, the *latter* option – taking money *out of the ladder* – could be the preferable alternative in today's unique fixed income environment.

Laddering can make sense for investors like Barry who prefer to own individual bonds during a "normal" bond market. Each of Barry's bonds are municipal bonds with the same AAA credit rating; the only difference between each bond is the time to maturity. During an ordinary fixed income environment, longer-term bonds of the same type and credit quality require a higher interest rate to attract investors like Barry. This is because rational investors demand a higher interest rate if they must wait a longer period of time to get their principal back. This relationship between bond interest rates of the same type and credit rating across time is known as the **yield curve**.

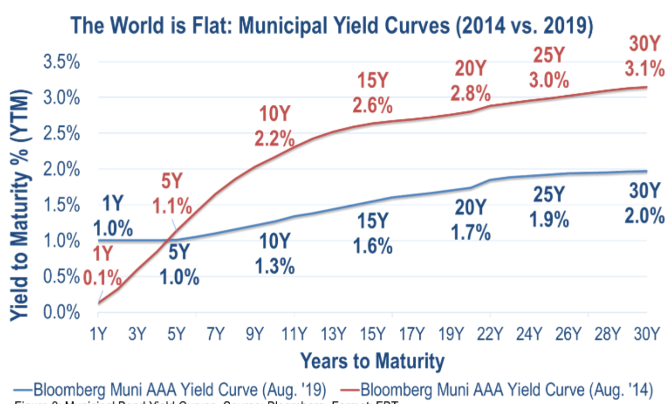

Figure 2: Municipal Bond Yield Curves. Source: Bloomberg. Format: FBT.

Ordinarily, the yield curve depicts yields increasing from left to right as the length of maturity increases (refer to the red line in the nearby Figure 2). However, the current interest rate environment is far from ordinary, as various economic factors have exerted their influence on the level of interest rates across the curve. **Today's yield curve, or yields available over time, has nearly flattened like a pancake** (as depicted in the blue line of the same chart). Longer-term rates have gradually been trending lower, primarily because today's bond buyers do not believe that short-term interest rates will be higher in the future. Rather, they believe that future rates will remain low (or potentially move even lower).

Wait, isn't that irrational? Actually, in the current environment, it's not. The trade and tariff wars that you've been reading about have impacted rates and exacerbated concerns regarding an already fragile global economy. For example, in an attempt to stimulate its economy, the Bank of Japan is offering *negative* yields for crying out loud – and the European Central Bank is pondering a similar policy. Back in the U.S., the Federal Reserve announced another rate cut last week – its second since July – attributing their decision to ongoing trade uncertainty and a weakened global growth outlook.

Let's revisit Barry Bond's decision from the opening paragraph. Taking the proceeds from either a maturing or called bond today – and "climbing the ladder" to reinvest in a longer-maturity bond – does not make as much sense given the flattened yield curve in today's environment. As you can see in Figure 2 above, **there is no longer a ladder to climb**. Long-term rates have slid down a chute – and are now barely above short-term yields! Thus, Barry's "Option 2" – taking the money out of the ladder to spend or invest elsewhere – is likely the preferable alternative in today's environment. However, it is important to consider your unique investment objectives while weighing these two alternatives.

For the vast majority of investors, there are two primary benefits of owning bonds: 1) To provide a steady and relatively safe income stream and 2) To act as a potential cushion in a balanced portfolio if stocks experience a challenging ("bear") market. If you have bonds that are maturing relatively soon, our team at First Bankers Trust can help you assess the best way to invest the proceeds while meeting your goals.

Depending on whether your primary objective for owning bonds is **income** or **stability**, you could consider a few different alternatives:

- **Investing your bond proceeds in a money market fund.** Since a money market fund (i.e. cash) is essentially a "bond" of the shortest maturity, it can function as a portion of your fixed income needs. In today's rate environment, many money market funds provide comparable yields to longer-term bonds – without having to wait to get your principal back. For instance, the current yield on the money market fund used by First Bankers is 1.9%, vs. 1.7% for the U.S. 10-Year Treasury (as of September 20, 2019).
- **Investing in fixed income securities beyond municipal bonds.** If your primary goal is to increase your income, you could weigh the possibility of taking incremental credit risk in order to earn a higher yield. A well-diversified fixed income portfolio that contains corporate – or even high-yield – bonds could help to increase your income.
- **Investing in dividend-growing stocks.** Many high-quality stocks that pay investors rising dividends offer higher starting yields than longer-term municipal bonds, and are also worth considering as a source of income. In addition, our research shows that these types of stocks have historically exhibited less volatility than other equities during challenging market environments.
- **Incorporating U.S. government bonds as a part of your fixed income portfolio.** U.S. government debt was one of the only asset classes to increase in value during the 2008 financial crisis. Although U.S. Treasuries provide minimal interest income in today's environment, they could serve as a "cushion" as a part of a well-diversified fixed income portfolio.

As we continue to visit with you throughout the rest of the year, we are happy to provide our insight and advice regarding how you can best achieve your investment objectives during this unique rate environment. In the meantime, we continue to welcome your questions or comments.

Sincerely,

Your First Bankers Trust Team