Bonds & Bond Funds – The Next Wall Street Bombshell

Douglas J. Schulz [1] **Invest Securities Consulting, Inc.**

Table of Contents

---

[1] Douglas J. Schulz has worked in the securities industry for over 30 years. He is a Certified Regulatory Compliance Professional (CRCP). He has worked as a registered representative for such firms as Bear Stearns and Merrill Lynch. He has held numerous securities licenses and certifications such as the Series 24, 6, 7, 3, and he has also worked as a Registered Investment Advisor (RIA). Since 1989 Mr. Schulz has been a securities expert witness through his company Invest Securities Consulting, Inc. (Invest) which is based in southern Colorado. Invest has been hired to do financial investigative and due diligence work for brokerage firms, investment banking firms, publicly traded companies, individual investors and merchant bankers. Mr. Schulz has been involved in over 1,100 securities cases and has testified over 600 times. He has worked closely with regulators on numerous cases and is an arbitrator for FINRA. He co-authored a book Brokerage Fraud: What Wall Street Doesn't Want You to Know with Tracy Pride Stoneman, a nationally known securities attorney. In addition to being a successful book, it was favorably reviewed by both BusinessWeek and Complinet. Mr. Schulz has been quoted in almost every financial publication in the United States, and due to the popularity of his book was a regular guest on financial radio and television programs. He has been a prolific author of articles on securities regulation and securities arbitration. Some of his more sought after publications are on the issues of online trading and unauthorized trading. Douglas J. Schulz, Invest Securities Consulting, Inc., 301 Snowcrest, Westcliffe, Colorado 81252, 719-783-3230, Schulz@securitiesexpert.com, www.securitiesexpert.com.

INTRODUCTION

Seasoned securities and investment advisors are conditioned to anticipate and fear when Wall Street is going to drop the next bombshell on them. In the late '70s and early '80s it was the tax-sheltered deals such as triple net lease private placements, mainly consisting of barges and rail cars. Then in the '80s it was limited partnerships. In both the private placements and limited partnerships the upfront loads, commissions, and annual fees were such that estimates are that only 20% of investors ever made any money. Prudential Securities was one of the largest marketers of these limited partnerships and for that, it was socked with one of the largest fines by the SEC and a book titled Serpent on the Rock that chronicles the whole debacle.[2]

The '80s into the mid-'90s welcomed the "boiler room"[3] and "microcap" brokerage firms. These were the brokerage firms that, often through hard-sell cold calls, pushed newly registered, thinly traded securities onto the unsuspecting public. Firms such as Sterling Foster, Blinder Robinson, and even the big boys like Bear Stearns were major players.

Then Wall Street unleashed the technology and telecommunications bubble on the investing public which, fueled by the analyst scandal, induced a hysteria never before seen. Investors lost billions. The regulators (as typical – too late and after the damage has been done) concluded that the Wall Street analysts were merely incredibly high paid investment bankers in sheep's clothing, hyping and inflating tech and telecom stocks way beyond reasonable values. Additionally, the public finally learned that Wall Street analyst's stock ratings were as baseless as astrological mythology.

When the investing public finally recovered from the tech/telecom induced bear market of 2000 - 20003[4], Wall Street unleashed a second self-induced, disastrous bear market, this time caused by subprime debt. Once again, the greed on Wall Street that caused the packaging and promotion of junk debt made the earlier transgressions by junk bond king Michael Milliken look like child's play.

It's time for investors to be asking themselves, "What is the next scandal that Wall Street has up its slimy sleeves?"[5] In my opinion, and in the opinion of other securities

---

[2] The word "Rock" in the book title refers to the Rock of Gibraltar which was and is Prudential's logo.
[3] A popular movie "Boiler Room" highlighted the tactics used by these "bucket shop" brokerage firms.
[4] The worst three years in a row in the S&P 500 for almost a century.
[5] As Mr. Schulz points out numerous times in his book Brokerage Fraud: What Wall Street Doesn't Want You to Know, the vast majority of investment professionals are honest, hardworking individuals.

professionals, the next debacle will be the fixed income or bond market. If you include corporate bonds, municipal bonds, government bonds, both individually and as packaged products such as unit trusts, mutual funds and the like, you are talking about a market that dwarfs all others.[6]

Now consider that the bond market has been on arguably a 30-year bull run. And to add fuel to this brewing disaster, remember that interest rates on such classical investments as CDs, money market funds, and bonds themselves have had for a few years historically low yields/returns. This combination of events has allowed and caused Wall Street to peddle alternative, fixed income investments and riskier bonds on the unsuspecting, yield-seeking public.

When interest rates rise, the devastation to investors' portfolios will be multiples of earlier debacles.

QUICK PRIMER: BONDS ON THE RISK-REWARD SPECTRUM

Since a large portion of my current profession is acting as a securities consultant and securities expert in litigation between investors and the brokerage and investment advisory industry, this article is slanted toward issues that are relevant to the recommendation and sale of fixed income securities to the investing public. Though a number of these issues are addressed in more detail below in the Litigation section of this paper, I feel it important at the outset to put to rest the issue of where bonds and fixed income securities "fit" in the investment spectrum for investors.

Stockbrokers/Registered Representatives and Investment Advisors are licensed individuals and are required under their licensing to pass certain examinations.[7] I first entered the securities industry professionally in 1980 working for Investors Diversified Services, IDS, conducting financial planning and selling mutual funds and related products. Quickly thereafter I went to work for Merrill Lynch as a Registered Representative and went through an extensive training program. The securities regulations and specifically FINRA (Financial Industry Regulatory Authority) Rule 2090 requires brokers to know and understand their clients investment objectives, risk

---

[6] In 2009 the World Bond Market was estimated at $82 trillion, whereas the World Stock Market was estimated at $32 trillion.

[7] The author has had to take and study for numerous examinations in his 30+ years in the industry.

tolerance and other material information before making recommendations. This is because FINRA Rule 2111, the Suitability Rule, requires brokers to only recommend to their clients investments which are suitable based upon such factors.[8] When testifying, I often refer to the suitability process as the ABC Process: A) the broker must fully understand his client's needs; B) the broker must fully understand the investment product he's considering recommending to the client, and C) the broker can only recommend the investment if the product matches the client's needs, desires and risk tolerance.

As investment professionals, we are taught that no single investment is sold in a vacuum and that we must fully understand all the various types of investments that are available in the marketplace. We go through rigorous training so that we can evaluate each of these investments on a comparative basis. We must know not only all the features and potential benefits of each of these investments and how they relate to the individual investor; we must also fully understand and appreciate the various risk and negatives that come with each investment.

FINRA too has chimed in on this issue of brokerage professionals' obligations to understand the products they are recommending and selling:[9]

"*A reasonable basis suitability analysis requires a firm to understand the investment products it sells. Accordingly, a firm must perform appropriate due diligence to ensure that it understands the nature of a product that it is recommending, including its potential risks and rewards.*"[10]

"Conduct Rule 2310 provides that when recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. This rule obligates representatives (1) to fully understand the securities they recommend and the consequences of those recommendations, and (2)

[8] See two previous articles written by Douglas Schulz: "Risk Tolerance of Investors" and "Investors Level of Knowledge", published in Guide to Investment Advisory Services, Practitioners Publishing Company, 1999 (6 volume training manuals) available at www.securitiesexpert.com/articles/.

[9] On the issue of the due diligence obligations of securities professionals, see also, "Due Diligence - Securities Applications and Regulatory Requirements 2011", Douglas J. Schulz, PIABA BAR JOURNAL Volume 17, No. 4 2010.

[10] FINRA Regulatory Notice 08-82, December 2008, "Cash Alternatives - FINRA Reminds Firms of Their Sales Practice Obligations with Regard to Cash Alternatives".

to make a customer-specific determination of suitability and to tailor their recommendations to the customer's financial profile and investment objectives." [11]

In a FINRA Notice to Members (NTM) in 2003, FINRA wrote the following:

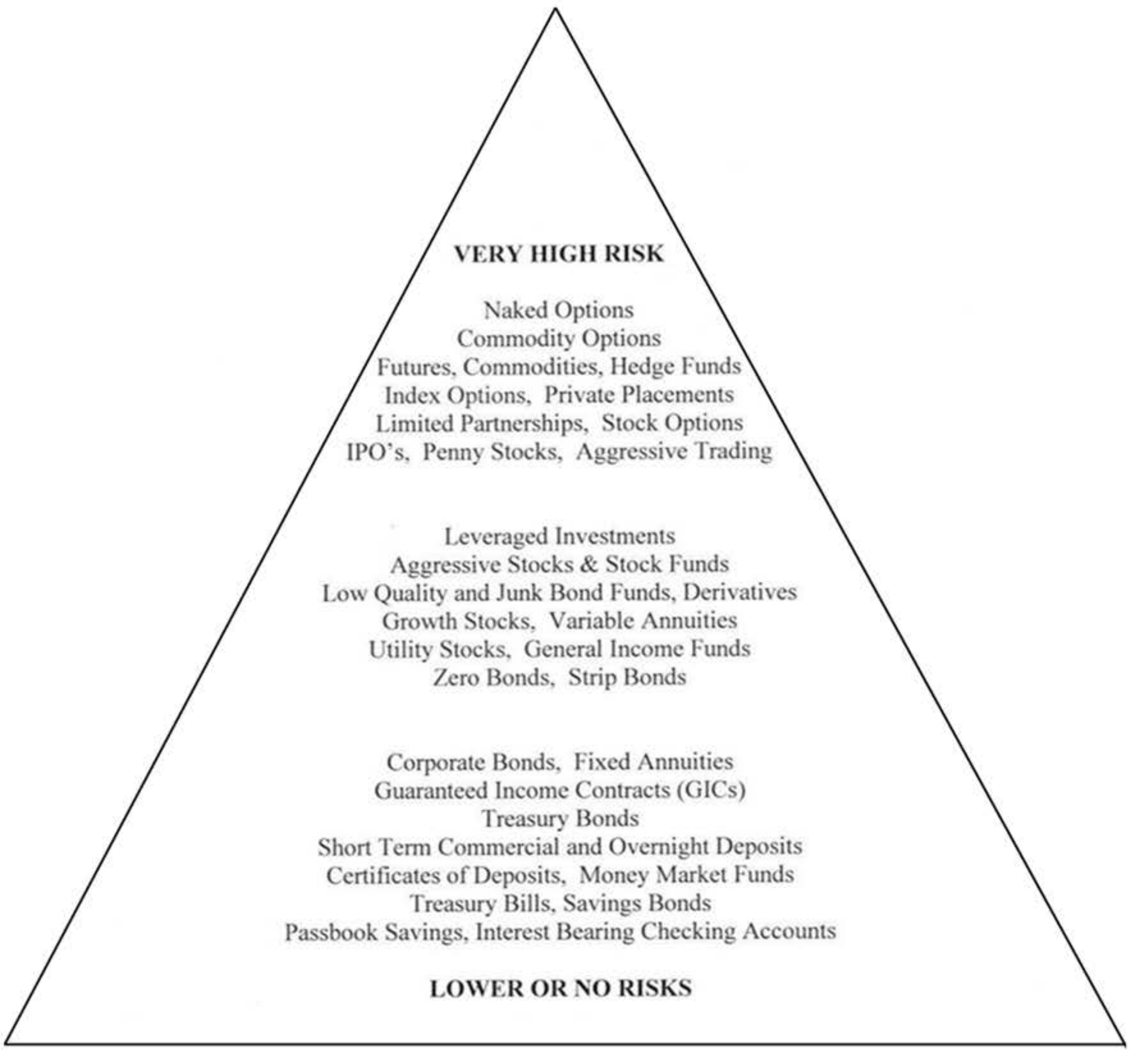
"*This Notice to Members reminds members offering NCIs (Non-Conventional Investments) of their obligations to: (1) conduct adequate due diligence to understand the features of the product. .... Although these products may have attractive qualities, it is crucial that members understand the distinct features, and risks and rewards, of any product they sell. ... Thus, whenever members recommend NCIs to investors, they must take special care to ensure that all registered persons understand the features of the product in order to be in a position to perform the required suitability analysis before executing a transaction. ... Thus, the reasonable-basis suitability analysis can only be undertaken when a member understands the investment products it sells. ... Accordingly, a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product."* [12]

One of the more basic investment tools utilized by both brokers and Investment Advisors is something referred to as the "investment pyramid". The investment pyramid serves two functions: first, it ranks investments from the lowest risk investments at the bottom of the pyramid to the highest risk investments at the top of the pyramid. Second, the pyramid shape suggest that a larger portion of an investor's portfolio should be in the safer, more conservative investments and only a small portion should be in the riskier investments. The pyramid is on the next page.

[11] Before The National Adjudicatory Council NASD Regulation, Inc., In re District Business Conduct Committee For District No. 1, v. Joel Dean Moore, Complaint No. C01970001 (August 9, 1999). In re F.N. Kaufman & Co. of Virginia, 50 S.E.C. 164 (1989).

[12] FINRA NTM 03-71, November 2003, Non-Conventional Investments

INVESTMENT PYRAMID



With minor variances, there are five terms used by the securities industry to describe investor's investment objectives/risk tolerances: conservative, income oriented, moderate/balanced, growth, aggressive growth and speculation. Another general standard in the securities industry is that equity/stock investments are for growth oriented investors and those willing to accept more risk. Commensurately, fixed income investments are for more conservative investors and those wanting or needing income.

Another traditionally accepted norm under suitability standards and proper financial planning is that a person's age is a guideline as to the use or mix of stocks versus bonds. A widely held belief in the money-management business is that growth investments such as stocks are for younger individuals who are in the early or midpoint of their careers because if their principal is lost, the individual has both the ability and time to make up the losses. The opposite is true for older individuals; their primary investments should be conservative investments where the risk of principal is minimal. And as retirement becomes more eminent, the stress should be on income-oriented rather than growth-oriented investments.

In 1981 when I was training to be a registered representative at Merrill Lynch, I was given a massive set of volumes on the securities industry.[13] Under the section "Speculation and Risk", brokers were taught one of the most basic fundamentals in the securities industry - the difference between debt securities (bonds) and equity securities (stocks).

"By legal contract, the issuer of a bond unconditionally agrees to repay the principal amount. Thus, a feature of a debt security is that the principal amount invested is safer than it would be in equity securities.

While common stocks generally have the potential for market price appreciation, they carry a much higher degree of capital risk then debt securities."

Enter 2013: is it possible that the teachings and standards for almost a century have been turned on their heads? Are bonds now riskier investments than stocks? Few in the investing public know or appreciate this potential damaging change of events. Yet those on Wall Street and in the securities industry are required to know under the securities laws and regulations.

[13] The Securities Industry, a Program for the Professional Account Executive, Merrill Lynch Training Department, 1980.

THE MARKETING OF FIXED INCOME SECURITIES

I noted earlier that securities professionals are trained and required to know the risk/reward ratio between stocks and bonds. Additionally, both naïve and sophisticated investors have a general opinion that bonds are <u>safer</u> than stocks. When it comes to investing I am often quoted as saying, "There is nothing more dangerous than an investor with limited knowledge and a general opinion." The securities industry has learned to take advantage of these "general perceptions". It is in this environment that less than scrupulous firms and brokers can take advantage of the investor by selling them fixed income securities that are not, in fact, suitable for their needs, goals, and risk parameters.

Numerous securities regulations require licensed securities professionals when selling or recommending investments to investors and potential clients to disclose all material facts relating to the particular recommendation. We often refer to this requirement as "full disclosure". Additionally, the securities regulations require in the sale of a security that the broker/advisor not <u>omit</u> any material facts relating to the underlying investment. The most often referred to anti-fraud regulations are FINRA Rule 2020 and the provisions under the Securities Exchange Commission, SEC, Rule 10b-5.[14]

Being a securities expert for 24 years and involved in over 1,100 cases, my experience has been that when violations occur in the selling of a security it is mostly on the side of omissions. That being said, what are some of the required disclosures under the securities regulations when selling fixed income investments such as bonds? The following list is not meant to be totally inclusive, but merely to highlight some of the essential, required disclosures:

- the current price of the bond
- any cost in acquiring the bond, such as commissions, spreads, markups, fees, and accrued interest that may need to be paid
- in the case of bond funds or unit-trusts, the annual fees, costs, 12b-1 charges and their effect on yield and potential performance
- an explanation of how these annual cost compare with other, similar investments and how costs can impair capital

[14]FINRA Rule 2020 "Use of Manipulative, Deceptive or Other Fraudulent Devices" and the Securities Act of 1934, 17 C.F.R. 240.10b-5" "Employment of Manipulative and Deceptive Practices".

- the bond format and how it is registered
- for a particular bond, the size or block size that the bond typically trades
- a history of bond pricing, on both a short-term, midterm and long-term basis
- if the bond is callable, an explanation of the call provisions
- the current yield, the yield to maturity, and the yield to call
- the specific type of bond (just saying it is a municipal bond is not enough, for example, is it a general obligation (GO), revenue bond, etc.?)
- the amount and timing of the bond payments

In addition to these disclosures, the broker/advisor must make the investor fully aware of all of the risks related to this type of bond or fixed income investment. Some of these general risk disclosures would include the following:

- inflationary risk - fixed-income investments historically underperform other investments during times of inflation
- credit risk – the meaning of rankings issued by such reporting agencies such as Moody's and Standard & Poor's
- interest rate risk - bond prices move inversely to interest rates; as interest rates go up, bond prices go down
- comparative and historical explanations of how bonds have performed both individually and against other potentially suitable investments
- an explanation how if interest rates were to move (using various scenarios and percentages), the potential losses in both dollars and percentages that could occur

More specific risk disclosures would include some of the following:

- any and all material facts affecting the credit worthiness of the underlying issuer of the bond
- the maturity date of the bond, since the longer the maturity the higher the risk (in the case of a bond fund this would include ranges of maturities and duration)[15]

---

[15]The duration number is a complicated calculation involving present value, yield, coupon, final maturity and call features. Fortunately for investors, this indicator is a standard data point provided in the presentation of comprehensive bond and bond mutual fund information. The bigger the duration number, the greater the interest-rate risk or reward for bond prices. Investopeia.com and "But just as some people's skin is more sensitive to sun than others, some bonds are more sensitive to interest rate changes than others. Duration risk is the name economists give to the risk associated with the sensitivity of a bond's price to a one percent change in interest rates." FINRA Investor Alert Duration – What an interest rate hike could do to your bond portfolio, 2013

- any and all liquidity or lack of liquidity issues surrounding the bond or the bond fund

The NASD/FINRA has similar language in their Notices to Members;

"Given that interest rates are likely to rise from their current and historically low rate, NASD believes that it is imperative that investors understand the various risks, as well as the rewards, associated with debt securities. The purpose of this Notice, therefore, is to remind firms of their sales practice obligations in connection with bonds and bond funds. The obligations include:

- *Understanding the terms, conditions, risks, and rewards of bonds and bond funds they sell (performing a reasonable-basis suitability analysis);*
- *Making certain that a particular bond or bond fund is appropriate for a particular customer before recommending it to that customer (performing a customer-specific suitability analysis);*
- *Providing a balanced disclosure of the risks, costs, and rewards associated with a particular bond or bond fund, especially when selling to retail investors;*
- *Adequately training and supervising employees who sell bonds and bond funds; and*
- *Implementing adequate supervisory controls to reasonably ensure compliance with NASD and SEC sales practice rules in connection with bonds and bond funds."*[16]

Another FINRA regulatory notice 08-81 from December 2008 reminds licensed securities professionals of something I have been stressing in expert testimony on the issue of "full disclosure" for decades. Licensed brokers and advisors are allowed to talk about all the positives of a particular recommendation, but they cannot do it in a way that emphasizes the positives and deemphasizes the negatives and risks of a particular investment and how that may impact a particular investor. Doing so would present an "unbalanced", "unfair" or "improper" sales presentation and would be a violation of the securities regulations.

"Sales materials and oral presentations must present a fair and balanced picture regarding both the risks and benefits of investing in these products. FINRA reminds

[16] NASD NTM 04-30 April 2004, "Sale of Bonds & Bond Funds". See also NASD Conduct Rule 2310(b). For municipal securities, see Municipal Securities Rulemaking Board (MSRB) Rule G-19 "Suitability of Recommendations and Transactions; Discretionary Accounts".

firms that NASD Rule 2210 and IM-2210-1 require firms to ensure that statements are not misleading within the context in which they are made, and that firms must consider the nature of the audience to which a communication is directed."[17]

In the next section I discuss the historical returns for bonds, but one must consider the more recent historical returns in bonds when they are being marketed and sold and in comparison to stocks and other investments.

"Over the 10 year period ending in 2012, both large and small company stocks have performed below their historical averages. Bonds produced returns that were above their long-term historical averages, except for treasury bills, while inflation rates are slightly below their 87 year average."[18]

Years	Large-Cap Stocks	Long-Term Corp. Bonds	Long-Term Govt. Bonds	Inter-Term Govt. Bonds
5 Years 2008-2012	1.66%	10.47%	9.34%	5.73%
10 Years 2003 - 2012	7.10%	7.76%	7.51%	4.76%
20 Years 1993 - 2012	8.22%	8.25%	8.59%	6.01%

The figures reflecting bonds outperforming stocks could create a dangerous scenario where either inexperienced or unscrupulous brokers are selling bonds to investors because of their recent out-performance of stocks.

[17] FINRA Regulatory Notice 08-81, December 2008, High Yield Securities FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment.
[18] Ibbotson SBBI, 2013 Classic Yearbook, Market Results for Stocks, Bonds, Bills, and Inflation, 1926 – 2012, Morningstar, This assumes all reinvestment of dividends and interest.

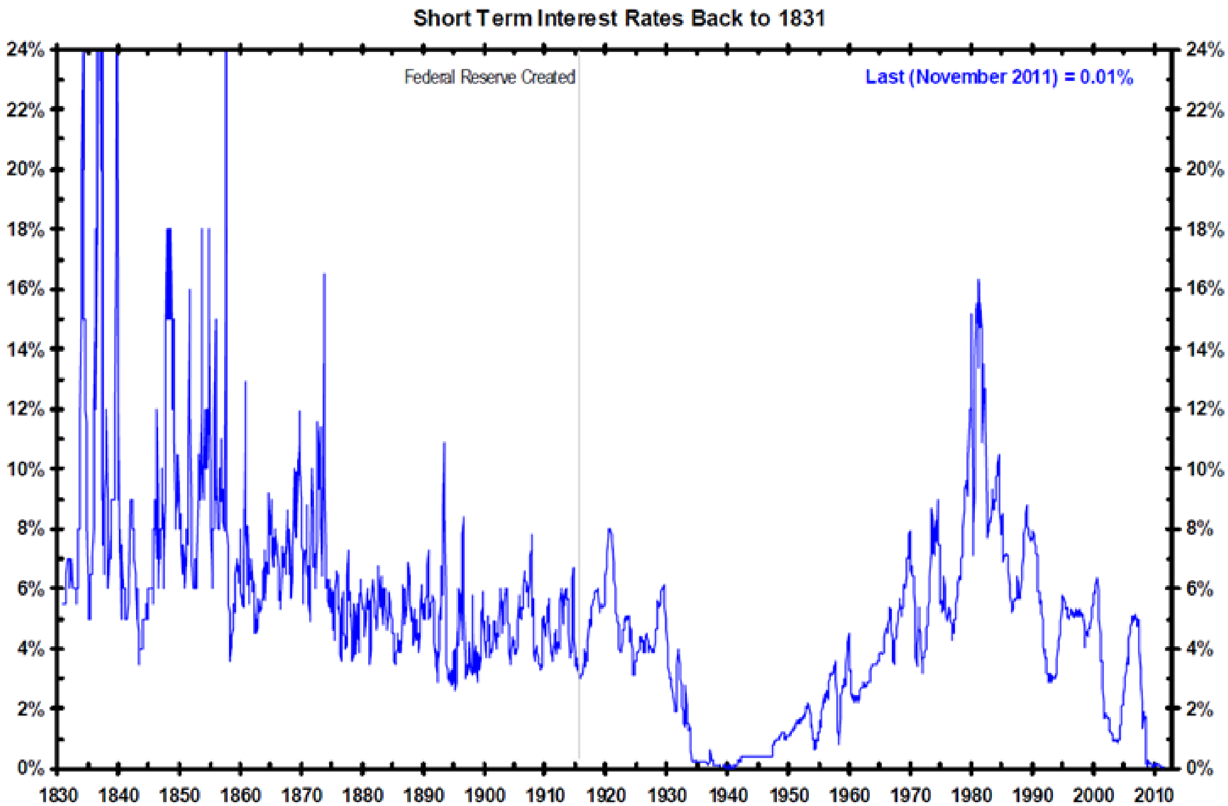
HISTORICAL PERFORMANCE OF FIXED INCOME INVESTMENTS

As of April 18, 2013 the following are the yields for various fixed income investments:

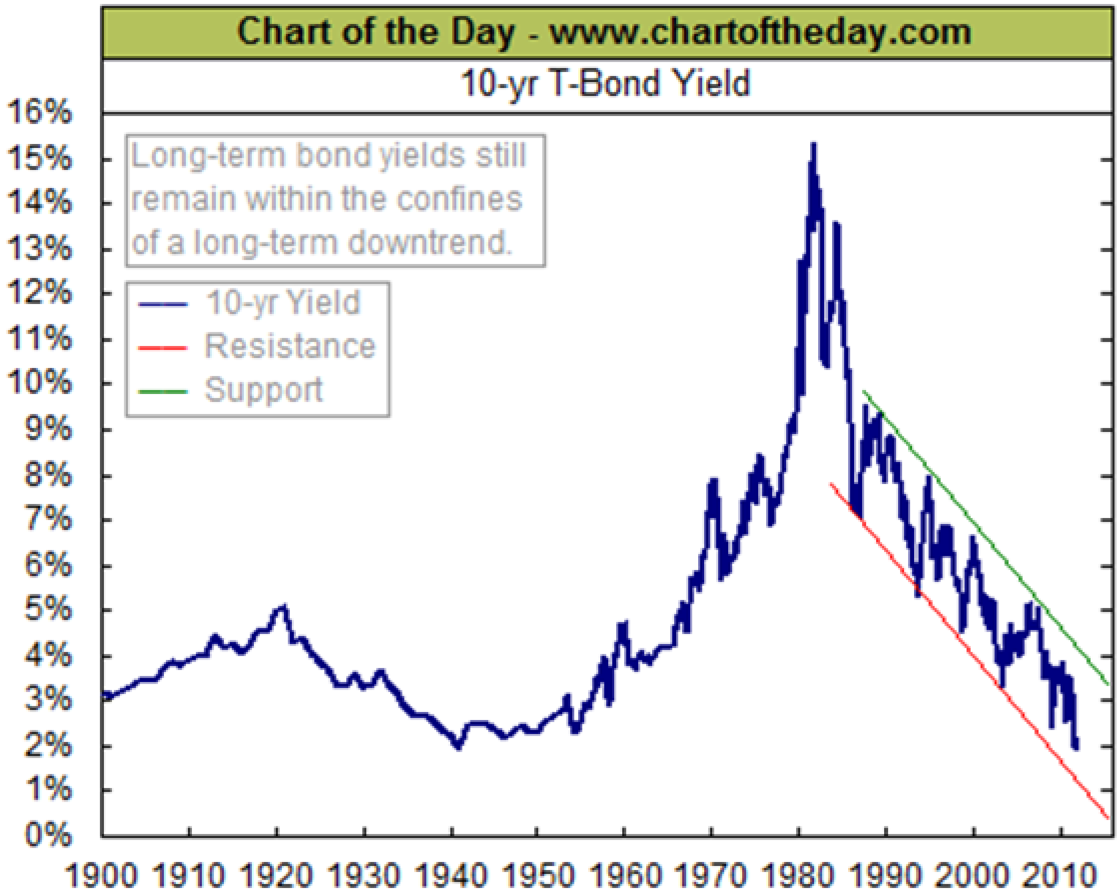
Maturity	US Treasury	Corporate AAA	Corporate BAA	Municipal Go AAA
1 – Month	0.036%			
3 – Month	0.053%			
6 – Month	0.089%			
1 – Year	0.117%	0.2992%	0.9634%	0.2798%
2 – Year	0.230%	0.4503%	1.2243%	0.3643%
3 – Year	0.339%	0.6288%	1.5328%	0.4789%
5 – Year	0.700%	1.1051%	2.2349%	0.7978%
7 – Year	1.124%	1.6878%	2.9741%	1.2259%
10 – Year	1.699%	2.4106%	3.5878%	1.9976%
20 – Year	2.5364%	3.4472%	4.7652%	3.4964%
30 - Year	2.8906%	3.4486%	6.4565%	3.8430%

Current yields April 17, 2013, Wall Street Journal online / Fidelity investments online.

To an experienced securities veteran, these numbers jump out as "Holy Moly, these are the lowest yields I have seen in my life!" But to the inexperienced fixed income investor, the following charts should help put these current yields in perspective.



Source: Bianco Research (via the Big Picture), December 16, 2011.



Source: Chart of the Day, December 16, 2011

You likely "get the picture". Yes, we are talking about interest rates that are the lowest they've been in 60 years. And for certain rates, some are the lowest ever. In 2012 long-term mortgage rates are the lowest they've ever been in history. This is also true for numerous other bonds and fixed income investments.

BUBBLE TERRITORY

Terms like "lowest" or "highest" in history conjure up the phrase "bubble" to securities professionals. An investment bubble can be described as follows:

"An economic bubble (sometimes referred to as a speculative bubble, a market bubble, a price bubble, a financial bubble, a speculative mania or a balloon) is "trade

in high volumes at prices that are considerably at variance with intrinsic values". It could also be described as a trade in products or assets with inflated values."[19]

Definition of 'Bubble'
1. An economic cycle characterized by rapid expansion followed by a contraction.
2. A surge in equity prices, often more than warranted by the fundamentals and usually in a particular sector, followed by a drastic drop in prices as a massive selloff occurs.
3. A theory that security prices rise above their true value and will continue to do so until prices go into free-fall and the bubble bursts.[20]

Investopedia explains 'Bubble'
"...During the boom people bought tech stocks at high prices, believing they could sell them at a higher price until confidence was lost and a large market correction, or crash, occurs. Bubbles in equities markets and economies cause resources to be transferred to areas of rapid growth. At the end of a bubble, resources are moved again, causing prices to deflate. Thus, there is little long-term return on those assets."[21]

"The Origin of Market Bubbles since 1926, we have witnessed many asset – price bubbles. The story seems to be the same. Positive feedback and herding among speculative investors produce runaway prices until the deviation from equilibrium is so large that the market becomes unstable, creating a high probability (or an inevitability) of a crash." [22]

History is littered with asset bubbles and the investors who were left penniless because of the brokers/salesmen who marketed, pushed, and hyped these assets before the bubble burst. What are the greatest investment/asset bubbles of all time? The tulip bulb craze; South Sea (stock) bubble; U.S. stocks 1928 through 1932; Japanese real estate and market bubble of the 1980s; Hunt Silver bubble 1978-1980; U.S. Internet and Telecom stock bubble of the late 1990s; and the great real estate and leverage and subprime bubble of 2007.[23]

Additionally, an article out of the United Kingdom provides a list of similar greatest investment/asset bubbles of all time and then asks the following question:

---

[19] Wikipedia.com
[20] Wikipedia.com
[21] Investopedia.com
[22] Ibbotson SBBI, 2013 classic yearbook, market results for Stocks, Bonds, Bills, and Inflation 1926 – 2012 MorningStar
[23] Bubbles in Asset Prices by Burton G. Malkiel, Princeton University, CEPS Working Paper No. 200, January 2010, Princeton.edu

"*Government bonds.....?*
So what might the next bubble be? Yields on government debt issued by countries perceived as the safest in the developed world have hit record lows over the course of the Eurozone debt crisis. The yield on UK 10-year gilts fell to within a whisker of a new record low in early trading this week at 1.924% - close to the all-time low of 1.922% seen at the end of last year. German bunds and US treasuries have also seen their yields hit record lows as investors have sought safety and this has led some commentators to wonder if government bonds could be the next bubble." [24]

Are we in a bubble? Let's take a look at what some other credible experts are saying:

"*Never in recent economic history have interest rates been so low for so long. ... On March 29 (2013) the average rate on a 30 year mortgage was just 3.57%, not far above the 3.31% reached in November, the lowest since data started to be compiled in 1971."*[25]

"Tuesday, February 5, 2013The Fed is in uncharted territory, having created a monster it can no longer control. In the process, it is blowing new asset bubbles that are benefitting those with first access to the newly-printed money (banks and corporations) at the expense of savers, pensioners, and anyone exercising fiscal prudence. ...When this misadventure in monetary policy ends, as both math and history says it must, it will be messy, uncontrolled, and very painful for holders of just about every sort of financial instrument out there (stocks, bonds, derivatives, etc).
One of the key impacts of the Fed stuffing all of this thin-air money out into the system is that all sorts of paper assets will be forced up in price. That's just a 'feature' of QE, if you will. ...For now, bonds are the most expensive they've ever been in history, and I'm pretty sure there are staggering losses to be had there at some point in the future. Further, stocks are being carried along on this wave of liquidity as well."[26]

"*Federal Reserve official said in a speech on Thursday. Jeremy C. Stein; A Fed governor (a Senior Federal Reserve official) said in a speech on Thursday some of the following comments:*

"We are seeing a fairly significant pattern of reaching-for-yield behavior emerging in corporate credit," Mr. Stein said in St. Louis. The Fed has held short-term interest rates near zero since late 2008, and amassed almost $3 trillion of Treasury securities

---

[24] History's Nine Worst Asset Bubbles... And One Set to Burst? Author: Hannah Smith IFA online | 17 Jan 2012 | www.ifaonline.co.uk (United Kingdom)
[25] Six Years of Low Interest Rates in Search of Some Growth, The Economist, Page 30,April 6, 2013.
[26] Why You Really, Really Need to Care about the Implications of QE by Chris Martenson, Tuesday, February 5, 2013, Peak Prosperity Insider

and mortgage-backed securities. The caution of chastened investors is one factor restraining the economic recovery. By lowering the cost of borrowing and limiting the availability of safe investments, the central bank is both pushing and pulling investors to take larger risks. But low rates can help to drive asset prices to unsustainable levels, as in the dot-com bubble that popped in 2000 and, of course, the recent housing bubble. Critics of the Fed's policies have pointed to the junk bond market as an area where low interest rates are encouraging excessive speculation. Investors are eagerly providing money to companies and countries with low credit ratings, and they are accepting historically low junk bond interest rates in return. Junk bond issuance in the United States set a new annual record last year — by the end of October. "We must not ignore the possibility that the low-interest rate policy may be creating incentives that lead to future financial imbalances," Esther L. George, the president of the Federal Reserve Bank of Kansas City, warned in a speech last month."[27]

"Corporate credit and high yield bonds are somewhat exuberantly and irrationally priced. Spreads are tight, corporate profit margins are at record peaks with room to fall, and the economy is still fragile…Admittedly, returns for both high yield and equity markets have been unduly influenced in the past few years by Quantitative Easing, the writing of trillions of dollars of Federal Reserve checks and the exuberant migration of institutions and households alike to the grassier plains of risk assets dependent on favorable economic outcomes. It is what central banks encourage and to date it has been successful. If and when that support dissipates or if the economy remains anemic, investors should be cautious and temper their enthusiasm."[28]

If a person needed one more excellent example of how interest rates (and correspondingly increases in bond prices) are at historically low rates of return, take a look at junk bonds.

" *The Barclays U.S. Corporate High Yield index fell to a record low of 4.97% Tuesday, marking the first time the benchmark tracking debt issued by weaker U.S. companies dropped below 5%. On Wednesday, it fell to 4.96%. The yield on the index has lost more than a percentage point this year, in a sign of hefty demand for income-producing securities.*" [29] Speaking of the new low yields on junk bonds the article went on to say:

---

[27] Fed Governor Raises the Specter of a Bubble in Junk Bonds By Binyamin Appelbaum New York Times, February 7, 2013

[28] "Rational Temperance" Investment Outlook, William Gross, Managing Director PIMCO, March 2013

[29] Yields on Junk Bonds Reach New Low, Kathy Burne, Wall Street Journal, May 9, 2013

"*You don't have much alternative right now," said Nick Prala, a corporate-bond trader at Loomis, Sayles & Co., which oversees about $150 billion in fixed-income assets. "This is what happens when you force yields to all-time lows and people still need incremental income.*"

With the huge rally in junk bonds, there is an additional risk to investors in these lower quality, fixed income investments, and that is that they are being priced at a premium to their ceiling/call features. Ignoring all the other risks relating to junk bonds, this is a risk that's being ignored by fund managers and investors. "There is a built-in break, so to speak to keep them anchored," said Eric Gross, credit strategist at Barclays. "Valuations are absolutely stretched," said Gibson Smith, co-chief investment officer of fixed income at Janus Capital Management LLC.

"So bonds have become a kind of Giffen Good,[30] things more highly sought after the more expensive they've become. Observe the rush of money into bond funds. Behold the plunge in yields of every description. With last week's sale of $600 million of BB – rated, five-year notes by CNH Global at an interest cost of just 3 5/8% gave proof that the phrase "high-yield securities" is now an oxymoron. The bond bull market that started in 1981 is closing on its 32nd birthday."[31]

Another problem is that the lowering and compression of yields distorts comparisons between various grades of fixed income investments. "At next-to-nothing percent, one credit looks much like the other. The blurring of gradations in credit quality, owing to the undifferentiated flight into fixed-income securities, will do nothing to enhance the reasonable allocation of capital." [32]

Need more evidence of a bubble? Keep reading.

"If we need any evidence the past thirty years, especially the past twelve or so, have been horrid for investors, this Bloomberg article notes that (government) bond returns have actually beaten stock returns over thirty years. Ouch. They say stocks win out in the 'long run' but for the average person's life span, you don't want to go out forty years to get a superior return. Obviously this is very atypical – it's the first time it has happened since the Civil War time frame!

---

[30] Definition of Giffen Good: A consumer good for which demand rises when the price increases, and demand falls when the price decreases. This phenomenon is notable because it violates the law of demand, whereby demand should increase as price falls and decrease as price rises. Investopedia.com

[31] Cooperstown of Yield, Grant's Interest Rate Observer, volume 31 No.9,Page 11, May 3, 2013

[32] Break All in Billiards, Grant's Interest Rate Observer, Page 2, Volume 31 number 8 April 19, 2013

To be fair, yields were very high on government bonds in the early 80s/late 70s as Paul Volcker was fighting off inflation so the starting point for prices was quite low in a relative sense (prices low, yields high), but it's still an amazing statistic.
Just more evidence we should never stop QE'ing – QE for 30 years and more artificial returns will make us all mad money!

- *The biggest bond gains in almost a decade have pushed returns on Treasuries above stocks over the past 30 years, the first time that's happened since before the Civil War.*

- *Fixed-income investments advanced 6.25 percent this year, almost triple the 2.18 percent rise in the Standard & Poor's 500 Index through last week, according to Bank of America Merrill Lynch indexes. Debt markets are on track to return 7.63 percent this year, the most since 2002, the data show. Long-term government bonds have gained 11.5 percent a year on average over the past three decades, beating the 10.8 percent increase in the S&P 500, said Jim Bianco, president of Bianco Research in Chicago.*

- *The combination of a core U.S. inflation rate that has averaged 1.5 percent this year, the Federal Reserve's decision to keep its target interest rate for overnight loans between banks near zero through 2013, slower economic growth and the highest savings rate since the global credit crisis have made bonds the best assets to own this year. Not only have bonds knocked stocks from their perch as the dominant long-term investment, their returns proved everyone from Bill Gross to Meredith Whitney and Nassim Nicholas wrong.*

- *"The generation-long outperformance of bonds over stocks has been the biggest investment theme that everyone has just gotten plain wrong," Bianco said in an Oct. 26 telephone interview. "It's such an ingrained idea in everyone's head that such low yields should be shunned in favor of stocks, that no one wants to disrupt the idea, never mind the fact that it has been off."*

- *Stocks had risen more than bonds over every 30-year period from 1861, according to Jeremy Siegel, a finance professor at the University of Pennsylvania's Wharton School in Philadelphia, until the period ending in Sept 30. The last time was in 1861, leading into the Civil War, when the U.S was moving from farm to factory, according to Siegel, author of the 1994 book "Stocks for the Long Run," in a telephone interview Oct. 25."*[33]

---

[33] Bonds Beat Stocks Over Past 30 Years, First Time That's Happened Since Civil War, Tuesday, Bloomberg News, November 1, 2011

"While bonds' bull market could continue, "The potential for negative return in fixed income has never been higher" in recent decades, said Fran Kinniry…" [34]

A discussion of bubbles is incomplete without mentioning that the historically low interest rate environment is creating a potential bubble in assets other than bonds. That comes as no surprise since yields are being forced down by various governments' attempt to force investors away from safe, income producing investments and into higher risk investments such as stocks and real estate.

"Excessively low rates helped create bubbles because they allow investors to ignore the cost of financing and concentrate on capital gains if their strategy works: they let people forget risk and focus too much on reward. Encouraging the revival of property market in the doldrums, risk creating a boom that will simply lead to another bust."[35]

If it is a bubble, when will that bubble burst? If I knew that, I'd be more famous and richer than Bill Gross or Bill Gates. The question is not "if" but "when". But let's next take a look at how we got to these historically low interest rates.

HOW WE GOT TO HISTORICALLY LOW INTEREST RATES

I do not intend to try to explain in this short article all the reasons that interest rates have hit historical lows, but a brief explanation is valuable. Numerous incidents in the '08 – '09 time frame sent economic shock waves worldwide. The precipitous market drop, the exposure of subprime debt, the undoing of two of the U.S.'s investment banks, Bear Stearns and Lehman Brothers, a bursting of the U.S. housing bubble, are just a few of factors responsible for the recession.

The elected politicians in Washington and various government officials subscribe to the Keynesian theory that government interjection is needed in slower economic times. The last few years this intervention by the Federal Reserve has been unprecedented. QE-1[36], QE-2, QE-3 and related bond purchases by the U.S.

---

[34] Fran Kinniry, She overseas target funds at Vanguard group. "Target" Funds Vulnerable to Rate Rise, Wall Street Journal section C, April 24, 2013.

[35] Six Years of Low Interest Rates in Search of Some Growth, The Economist, Page 31, April 16, 2013

[36] QE stands for quantitative easing. A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity. Investopedia.com

Government/Federal Reserve have attempted to pump up the economy to keep interest rates at historically low rates in order to encourage businesses to borrow and investors to seek higher risk equity investments such as stocks and real estate.

"*The very same fed that could not and did not see that a housing bubble was forming is now equally complacent about corporate bond yields touching all-time record lows across the entire spectrum, right down to CCC junk that sits one skinny notch above default."* [37]

"Prolonged periods of extreme monetary ease are good for journalist, governments and speculators, but not for savers and producers. We take this truth to be self-evident (although the IMF has lent its authority to the proposition in a new Global Financial Stability Report), and we accept as given that the central banks have no informed idea of what the money they conjure will finally do or to whom it will ultimately do it." [38]

"*On May 1st (2013) the fed duly said it would keep interest rates near zero, as it has since 2008, and keep buying $85 billion of government bonds a month, although it may vary the pace depending on the outlook for inflation and jobs. A prolonged period of low interest rates carries the risk of asset bubbles. In its annual report issued April 25 America's new Financial Stability Oversight Council (FSOC), a watchdog that includes the fed, warned that a "sudden spike in yields and volatilities could trigger a disorderly adjustment, and potentially create outsized risk." For its part, the IMF noted in its latest "Global Financial Stability Report" that "credit markets… Are maturing more quickly than in typical cycles." The FSOC and the IMF worry in particular about unusually low yields on long-term bonds. Suppose an investor expects short term rates averaged 2% for the next 10 years. A 10 year bond need only yield 2% to provide the same expected return. But investors and long-term instruments usually demand a few percentage points more, a difference called the "term premium", to compensate for the possibility the world turns out differently. <u>The term premium is now around zero</u>, according to the FSOC.*

The fed's purchases have squeezed the supply of risk-free government debt, forcing investors with particular need for such paper, such as life insurers, to accept much lower yields. Finally the hunger for safe assets may have elevated demand for treasuries. This is potentially worrying. Changes in expected short term rates account for most bond market selloff. In 1994 rapid Fed tightening led to a bloodbath in bond markets."

---

[37] How to Survive the Mother of All Bubble Bursting's: A Collapse of the Bond Market, Chris Martenson, Peak Prosperity, March 21, 2013
[38] Break All in Billiards, Grant's Interest Rate Observer, Page 2, Volume 31 number 8 April 19, 2013

Then again, holding down long-term interest rates and encouraging investors to take more risk is the whole point of the fed's policies; if successful, it will revive demand and- economic growth. That this also raises risk to the financial system is a trade-off the fed seems prepared to live with."

More interesting perhaps than how we got to low interest rates is what will happen when interest rates rise.

EFFECTS OF RISING INTEREST RATES

You might ask, "Why isn't there a section in this article about the effects of lowering interest rates?" Excellent question. And on the immediate horizon, there is an argument among financial academics that even though interest rates are at incredible and historic lows, there is at least a chance they could go a bit lower. The argument for this possibility is that with the potential of both Europe and Japan falling off the face of the earth economically, that even as bad as the United States looks, it doesn't look so bad in comparison. As foreigners veer away from fixed income investments in these potentially worse off countries, they drive the prices of U.S. treasuries, and to a lesser degree U.S. corporate bonds, to even higher prices which inversely means lower yields. But since there will be a 1000 percent higher number of securities cases in litigation because of higher rates not lower rates, we will only consider one side of this equation. Additionally, as you can see from both my opinion and the opinion of other studious financial professionals, the much greater risk from these historically low interest rates is clearly that rates rise. And rise they will; we just don't know when.

Before we look at the actual damage to be done to fixed income investments from rising interest rates, we need to step back just a bit to once again put things in perspective.

Why do fixed income investments go down in price when interest rates rise? "When new bonds are issued with interest rates of 13% or 14%, the prices of outstanding bonds, offered originally at 4% or 5%, are bound to decline. No one is going to pay face value for an old bond with an interest rate of 4% if you can buy a new bond of equal quality with an interest rate of 14%. The only way the old 4% bond could compete with the new 14% bond on even terms would be for the 4% bond to sell in the market at much less than one third of its original price. So, when interest rates rise, older bonds with low interest rates have a tendency to fall proportionally in price" [39]

[39] How to Buy Stocks, Louis Engle and Brendon Boyd, Seventh Edition, Bantam Books 1982, original printing 1953.

The list of variables that can affect the price of a fixed income security is long and complex and beyond this article. That being said, let's explore how rising interest rates, the key focus of this article, can affect fixed income pricing.

Generally speaking, the longer the maturity of a particular bond or group of bonds, the greater impact (market price volatility) changing interest rates will have on the security. Simply put, a 30-year bond has significantly greater volatility and sensitivity to interest rates than a five year bond. The major reason for this is uncertainty versus predictability. If you are three years into the maturity of a five year bond, regardless of which way interest rates go, you know you only have to wait two years for your bond to mature and for you to be paid your principal back. So ignoring all other factors, as a bond matures and gets closer to its maturity date, it becomes less and less sensitive to interest rate fluctuations.

There are additional complexities in the equation of sensitivity to interest rates between long and short term fixed investments. The following is a quote from the American Association of Individual Investors (AAII):

"The price that a bond sells for in the market today is the sum of all future cash flows, discounted in value because they are not available today. A dollar tomorrow is worth less to you than a dollar today. The discount rate used is the rate of interest prevailing in the market for bonds of the same risk and maturity. When that interest rate changes, it affects the price of all bonds, but to varying degrees.

The longer the maturity of your bond investments, the greater the price volatility. Why? The reason is that the maturity value of the long-term bond, as well as many of the interest payments that are being paid, are future cash flows that are very distant points in the future. If interest rates rise, those very distant cash flows of the long-term bond are discounted in value significantly, and the price of the long-term bond falls in the market abruptly. Coupon rates—the periodic interest payment that is paid by the issuer of the bond—also affect bond price volatility. A higher coupon means that more cash in the form of interest payments flows to the investor before maturity than is the case with a lower coupon bond. What this means is that when interest rates rise and future cash flows are discounted at a higher rate, the lower coupon bond has relatively more cash flow in the distant future, the maturity value of the bond represents a greater portion of the total cash flow, and the bond's value today will fall relatively more. Combining these characteristics produces the riskiest bonds in terms of price volatility:

The most price volatile bonds are those with longer maturities and lower coupons. A long-term zero-coupon bond defines the outer boundary for riskiness.[40]

The piece below from the same AAII article addresses the question of just how much the underlying market price of various bonds will change with the change in interest rates:

"*As an example of how to read the table, assume that you have a bond with a 30-year maturity and a 6% coupon rate. If you anticipate that interest rates will drop two percentage points, say from 6% to 4%, your bond will rise in value by 34.7%. A bond selling at a face value of $1,000 before the interest rate drop would rise to $1,347, for a gain of $347. On the down side, however, if interest rates instead rose to 8%, your bond would decrease in value by 22.6%, to $774, for a capital loss of $226. Both of these interest rate changes are a bit on the high side but not impossible, and the gains and losses are large because the bond maturity is so long. You can see from the table that the lower-coupon bond at the same maturity has greater price volatility. A higher coupon rate for the same maturity would result in smaller but still very significant price changes."*[41]

[40] How Interest Rate Changes Affect the Price of Bonds AAII January 2008 Investor Professor

[41] How Interest Rate Changes Affect the Price of Bonds AAII January 2008 Investor Professor (The table is based on the assumption of semiannual interest payments and bonds selling at their maturity (face) value. Because of the mathematics of the relative change, the gains are always larger than the losses for the same interest rate change.)

Table 1. Percentage Change in Bond Prices When Interest Rates Change				
4% Coupon Bond				
Years to Maturity	**Interest Rates Change By 1%**		**Interest Rates Change By 2%**	
	Rates Rise	**Rates Fall**	**Rates Rise**	**Rates Fall**
1	–1.0%	1.0%	–1.9%	2.0%
5	–4.4	4.6	–8.5	9.5
10	–7.8	8.6	–14.9	18.0
20	–12.6	15.0	–23.1	32.8
30	–15.5	19.7	–27.7	45
6% Coupon Bond				
Years to Maturity	**Interest Rates Change By 1%**		**Interest Rates Change By 2%**	
	Rates Rise	**Rates Fall**	**Rates Rise**	**Rates Fall**
1	–0.9%	0.9%	–1.8%	1.9%
5	–4.1	4.3	–8.1	8.9
10	–7.1	7.7	–13.5	16.3
20	–10.6	12.5	–19.7	27.3
30				

Now let's do the calculation ourselves (using one of the standard bond value calculators) using the current interest rates listed earlier in this article. Let's take a 30-year maturity, corporate AAA bond paying its coupon twice a year. The yield currently for that bond is 3.448%. Let's assume that the bond is selling at par, $1,000 face value per bond. Let's now assume that the interest rate on a similar bond has a 2% higher interest rate, which would make the current yield 5.448%. That would reduce the market price of your 3.448% bond to $706. That is a drop in price of $294 per bond, or a 29.4% drop in principle value (the AAII chart was a drop of 28%). And it is very important to note, you don't have to be trading in corporate or municipal bonds to see this kind of devastation in value. You can find these kinds of percentage drops in even the highest quality U.S. government bonds.

A similar drop in price was cited by a recent FINRA Investor Alert. But instead of just using maturity date, this formula used "Duration", which is defined elsewhere in this article:

"*A similar investment grade bond with a duration of 14.5 (30-year maturity, 4.5 percent coupon) might experience a loss in value of 26 percent. The higher level of loss for the longer-term bond happens because its duration number is higher, making it react more dramatically to interest rate changes.*"[42]

There are other factors of how changing interest rates affect different bonds in a different way. The following is from the same AAII article:

There are also some important qualitative factors that affect bond price changes. The table details price changes for bonds generically. The realities of the marketplace are that when interest rates rise, lower-rated bonds—those with higher default risks—tend to fall faster in price. This distinction holds for corporate and municipal bonds alike, but is obviously not relevant for U.S. government bonds.

A rise in interest rates in a deteriorating economic environment would drop the price of a low-rated bond—a high-yield (junk) bond—much faster than the price of a triple-A-rated corporate bond of the same maturity.[43]

I do not disagree with this author, but there is a very important point that often causes great confusion in the sales process between brokers and investors. Just because an investor is in highly rated, or highly ranked bonds, and they are considered some of the more conservative, safer bonds such as AAA rated municipal bonds or U.S. government bonds, a significant move up in interest rates can devastate the principle value of even these high-quality securities.

BONDS OF EVERY COLOR

One of the most interesting things I've learned having been in this business for so long is that the investing public understands very little about the details and nuances of the fixed income markets. And this is very understandable. Stocks are pretty basic - there are common stocks and preferred stocks. For the vast majority of all stocks, on any given day you can go online and get a current quote and sell your stock holdings through almost any broker-dealer and almost instantly. The opposite is true for bonds; the Wall Street Journal has pages and pages of stock quotes, but finding individual quotes for individual bonds is a limited exercise. Bonds come in about every color under the rainbow and, as mentioned earlier, the disclosures required

[42] FINRA Investor Alert Duration – What an interest rate hike could do to your bond portfolio. 2013
[43] *How Interest Rate Changes Affect the Price of Bonds* AAII January 2008 Investor Professor

when an advisor is recommending a bond are longer than those when recommending a stock. This is because there's just so much that can make one fixed income investment dramatically different than the other. The fact that the public doesn't fully appreciate this nuance, makes the disclosures that much more necessary. The following quote from FINRA/NASD 04-30 evidences this sentiment:

"Bonds and bond funds may be viewed—and in some cases, marketed—as low-risk, or sometimes even as risk-free alternatives to equity securities. Purchasers of bonds and bond funds often believe that their principal is safe, they are guaranteed a particular yield on their investment, and bonds are inexpensive to purchase because they do not pay a commission or other acquisition cost on the transaction.

For example, a recent study by NASD indicates that 60 percent of investors do not understand that, as interest rates rise, existing bond prices fall, and that long-term bonds are more exposed to interest rate risk than short-term bonds."[44]

If I attempted to go to into all of these specifics, not only on the types of fixed-income investments but then the particulars of each, this article would turn into a book.[45] The important point here for regulators, investors and litigators is that each of these different types of fixed income investments can act dramatically different and their price fluctuation can be exponential depending on the underlying characteristics. I have purposely not discussed all the nuances and characteristics of various types of fixed-income investments and bonds, but one must be aware that in discussing how the change in interest rates effects the value of bonds, these underlying characteristics become key. Here are just a few of some of those key characteristics that can become very important in a fluctuating interest rate environment.

- the underlying quality (including ranking)
- the maturity date (in funds this would also include the duration)
- the liquidity and marketability
- the current coupon/yield, yield to maturity, yield to call
- if a bond fund, if leverage is used
- if in a portfolio, if margin is utilized

Let's talk about this last point which is very key in the current environment. With short-term interest rates yielding almost zero and after taking into account taxes and

[44] NASD NTM 04-30 April 2004 Sales Practice Obligations NASD Reminds Firms of Sales Practice Obligations In the Sale of Bonds and Bond Funds
[45] Speaking of book, I discuss the specific of bonds and other investments in my book. Brokerage Fraud – What Wall Street Doesn't Want You to Know, 2002, Dearborn Publishing

inflation, many fixed income investments are currently experiencing a negative yield. Wall Street in an attempt to attract investors has boosted the yields of various fixed income unit trusts, mutual funds and even ETFs (exchange traded funds). Earlier, I gave you two examples in percentage and dollars of what an investor could lose if interest rates just moved up 2% on a 30-year bond. Now assume that same investor, instead of owning the bond fully paid for in a cash account, owns the bond in a margin account and the investor only put up 50% of the purchase price.[46] Imagine the loss of equity/principal on a long-term bond portfolio where only 50% margin was used and there's a 2% increase in yields as was used in our earlier example. You would have the same 28% reduction in value, but because of the use of 50% margin, the loss of principal would be 56%! Sure, the leverage increased the yield from 3.44% to almost 7% (minus the margin cost), but a loss of over half of the investor's money would mean that the investor would likely not recover his loss of principal maybe in his lifetime.[47] The following is a quote from an online investor education website:

"Just about the worst thing you can own when interest rates are moving up is a leveraged bond fund. When a fund manager borrows short term at low rates in order to buy additional long-term fixed-income investments for his fund, it's the equivalent of buying stocks on margin. It works fine while bond prices are flat or rising. But when bond prices fall – as they will when interest rates rise – these shareholders take a shellacking."[48]

The above author, Alexander Green, makes an additional key observation when it comes to the potential heightened risk in a volatile interest rate market. The author lists a number of some of the largest, more popular closed-end bond/fixed income funds that are selling at premiums.[49] These funds are selling at a premium because the underwriter/managers have boosted the yield through leverage. This has caused the offering price of these closed-end funds to be bid up above their Net Asset Value, NAV. This is a disaster waiting to happen if and when interest rates spike up. In this kind of environment, investors could be destroyed as the funds go from premiums to discounts to NAV.

---

[46] Fed call initial margin rates on stocks is 50%, the margin requirements on bonds is considerably less, and on U.S. government bonds it is only 10%. Currently at TD Ameritrade, its initial margin requirements on U.S. treasuries are 3% up to five years, 5% up to 20 years, and 10% 20 years plus in maturity.

[47] Most investors, and sometimes professional advisors, forget the fact that if a portfolio is reduced in value by 50%, that same portfolio going forward needs to make 100% just to get back to a break-even point.

[48] Investment U –Online, Bond Funds: The Worst Investment You Can Possibly Make by Alexander Green, Investment U Chief Investment Strategist, Friday, March 30, 2012: Issue #1741

[49] Closed end funds are unlike open-end mutual funds because they trade on the open market, and can sell for more or less than their Net Asset Value, NAV.

Another investor education website has the following to say about these kinds of leveraged fixed income products:

"*These investments are extremely volatile, so they are designed for only the most sophisticated traders, rather than longer-term investors. Exchange-traded products can take the form of either exchange-traded funds (ETFs) or exchange-traded notes (ETNs). The difference between the two is explained here.*

Risks of Leveraged Bond ETPs
The main risk of leveraged funds is that they are highly volatile. If you're not used to trading fast-moving securities, these securities aren't for you."[50]

BOND LITIGATION

Shortly after every bear market in the U.S. stock markets, arbitration claims at the self-regulatory organization FINRA increases. We can expect a similar increase in arbitration claims when the bear market in bonds raises its ugly head.

There will be a whole new twist on this eminent bond litigation versus the more traditional stock litigation. Even though Wall Street is guilty of pushing evermore stocks on investors as the NASDAQ and the New York Stock Exchange climb to even more lofty levels; behind the closed doors of arbitration, the securities defense lawyers are artful at trying to convince arbitrators that "everyone knows that stocks are risky." This well-heeled defense mantra won't carry much water when it comes to bonds though. Both the financial press and Wall Street have for decades lead investors to comparatively believe that stocks are for the aggressive investors and bonds are for the conservative investors.[51]

Litigation history has shown that one of the additional practices of Wall Street is to paint themselves as merely "order takers" and claimants as "greedy investors". Greedy investors? The Quantitative Easing policies of the U.S. government has been a godsend for those living on debt and credit, but these policies have devastated the yields and returns on the portfolios of the American savers and retired individuals.

---

[50] About.com Bonds What Are Leveraged Bond ETFs? By Thomas Kenny, About.com Guide (copied from website April 21, 2013)
[51] There are also millions of Americans who have been led to believe that even stocks can be conservative investments.

A word of caution to those entering into fixed income litigation. Keep a close eye on what was told to the investor about past, current, and potential future returns on fixed income portfolios. One of the biggest travesties being perpetrated on the American public today when it comes to the sales of fixed income investments is the practice of not clarifying for the investor the difference between "yield", "capital appreciation" and "total return". Bonds have been on a bull run for more than a decade (and arguably longer). Far too often unscrupulous securities salesmen quote the past "total return" to a prospective investor to entice them into a particular type of bond or bond fund. To make matters worse the same broker may purposely confuse yield with total return. In comparison, earlier yields on all types of fixed income investments look much more enticing than the historical low yields of today. But still if you strip out the capital appreciation in these fixed-income investments during this bull market, even those historical yields from just a few years ago weren't all that great. It is this reality that encourages unethical brokers to mislead investors about true comparisons. The devil is in the details - consider the returns for long-term government bonds for the three year period 2010 through 2012. The following is the breakdown of the returns for long-term government bonds. [52]

Year	Income Return	Appreciation Return	Total Return
2010	4.25%	5.89%	10.14%
2011	3.81%	23.74%	28.23%
2012	2.40%	.88%	3.331%

It would be misleading and a breach of the regulations governing full disclosure for a broker or investment advisor to laud the total return of bonds for the last three years but not disclose that those returns came mainly from appreciation, not income.

FINRA, formally the NASD, had as one of its initial regulatory pursuits regulating the sale and marketing of mutual funds. The regulators have always been very concerned about inappropriate sales tactics and specifically sales pitches that use past performance as an indication of future performance. The following is a NASD release in 1999:

"*NASD Regulation has commented when member firms have used communications that overstated a security's historical performance while obscuring its recent, less favorable track record. These situations have arisen when a security's performance has*

[52]Average maturity 20 years. Assumes all interest reinvested. Ibbotson SBBI, 2013 Classic Yearbook, market results for Stocks, Bonds, Bills, and Inflation 1926 – 2012 Morningstar

been negatively affected by sudden changes in market conditions. These changes could be a spike in interest rates, currency devaluations, or other similar factors that may affect a market sector. Typically, the data used in these communications is factually accurate; however, the time period for which it is reported fails to reflect a more recent time frame during which market conditions may have hurt performance severely. When such a significant drop in performance occurs, communications must include further disclosure in order to comply with NASD Conduct Rules."[53]

Though this release is more focused on brokerage firms not updating their performance numbers to reflect more recent changes; it is reflective of FINRA's attitudes about misusing past performance numbers.

Of course, with the advent of more merging of brokerage firms with traditional brick-and-mortar banks (for example, Bank of America/Merrill Lynch, Wells Fargo/Wachovia) the regulators are very concerned about how investors can be confused when their branch bank, where they have been purchasing CDs for decades, is now offering "alternative" fixed income investments. This is especially true when the brokerage/bank employee does not clarify the distinction and risk between federally insured CDs and other fixed income investments. The following is from an educational release for brokers by FINRA in 1996.

"*Similarly, when comparing a bond mutual fund to a CD, it is important to explain that should interest rates rise, the value of the bond mutual fund will fall, whereas the value of the CD will remain fixed until maturity. Please see Notices to Members 93-87 and 91-74 for more information regarding the offer of mutual funds to replace maturing certificates of deposit.*" [54]

Another tactic used by the securities defense industry in bond cases is a similar tactic they perfected in defending the limited partnership cases back in the late '80s and early '90s.[55] Veteran attorneys who specialize in defending brokerage firms will argue when it comes to damages, that the investor doesn't deserve both the return of his loss principal and his loss in interest payments. On its face, this defense argument is grossly unfair. But it is a well-healed tactic, and it can be expected.

Regulators, investors, and litigators need to be apprised of all the various types of fixed income products that could be affected from arising interest rate environment. One

---

[53] FINRA Website, Releases, RCA - Summer 1999 - Sudden Performance Changes May Require More Information Recently

[54] FINRA.org RCA - November 1996 - Ask The Analyst - CDs

[55] See "Damages and Limited Partnership Cases " by Douglas Schulz, PIABA VOL. 1 October 1993

vulnerable product is "target" funds. "The funds typically increase their bond holdings with the approach of the target date, which is pegged to the investors expected retirement year.... But if yields rise and bond prices slump, as many experts predict, the funds could suffer losses. "People think this is safe money," wrote Dave Scott chief investment officer of sunrise advisors... "Losing money in bonds is a brutal way to lose money."[56]

Though I have discussed municipal (tax-free) bonds little in this article they are also very susceptible to principal loss if interest rates rise. "Investors might conclude that... While the risk adjusted returns offered by municipal bonds may be negative, these returns might still exceed the returns on other investments in the low interest rate environment. In other words, in an environment of depressed yields, municipal bonds are the least bad investment." "The tax-exempt market should be careful when it finally does wake up. It might fall out of bed."[57]

Additionally, investors could be hurt by either direct investment or investment through a fund in foreign fixed income investments which have also appreciated greatly to the meddling of government intervention. Ten year French sovereign (government) bond yields has dwindled to 1.82% about as low as it has ever been. [58] [59]

This article has proven that there are distinct risks currently in owning certain types of fixed income investments, which has been heightened due to the historical bull market in these investments. But it turns out there are even additional risk in certain bond funds. It turns out to juice the return; certain bond fund managers have started adding stocks to their holdings.

" *The number of bond funds that own stocks has surged to its highest point in at least 18 years, another sign that typically conservative investors are taking bigger risks to boost returns... Bond and income funds have broad leeway to invest in other securities. The Securities and Exchange Commission generally requires funds to invest at least 80% of their assets in the type of assets suggested by their names. But certain words with vague meanings, like "value" or "income," don't trigger the requirement... Some funds, however, are piling into equities. The $15.4-billion*

---

[56] Target funds vulnerable to rate rise, Liam Pleven and Joe Light, Wall Street Journal, section C, April 24, 2013.

[57] Tropical Storm, Grants Interest Rate Observer, Volume 31 Number Seven, Page 9, April 5, 2013.

[58] Break All in Billiards, Grant's Interest Rate Observer, Page 2, Volume 31 number 8 April 19, 2013

[59] Additionally, the Japanese have created a huge amount of government debt in its purchasing of debt instruments to drive down interest rates. "At some point, however, action will be needed. At over ¥1 trillion, the sheer size of the debt weighs ever more heavily. The cost of servicing it eats up over half of (Japan's) tax revenues." American Bond Markets – Term Report – Regulators Fret about the Risk of a Sudden Rise in Long-Term Bond Yields, The Economist, Page 73-74, May 4, 2013.

Loomis Sayles Strategic Income fund has ratcheted up its stock and preferred-stock allocation to more than 19%, from 5% in mid-2011. Co-portfolio manager Matt Eagan said that the fund's managers decided most bonds were so overpriced that it was worth taking on some stock risk to avoid pain in bonds."[60]

Finally, let's go back to our earlier example where the investor was sold what was supposedly a relatively stable and safe high quality AAA rated corporate bond. In our example, the bond was a 30 year bond yielding 3.448%. Just how suitable was it to sell an investor who is looking for income and safety, a bond yielding an annual return of only 3.4%, when a significant move in interest rates could wipe out almost 30% of the investors equity? Of course, the brokerage industry and its lawyers will argue if the investor is patient enough, young enough, and has no need for the cash invested in this investment, and nothing happens to the underlying entity or corporation that underwrote the bond over the next 30 years, then all is well. But that's a lot of "ifs" and a scenario that rarely plays out in the real world of investing.

CONCLUSION

When discussing this article with one of my non-securities friends, he queried; "Why the discussion of litigation in your article about losses in the fixed income markets caused by rising interest rates?" I explained:

Recommending that an investor buys assets selling at historically low yields; historically high prices; potentially even bubble-like prices; with no adequate warning and a full explanation of the potential risk of losses is a serious violation under numerous securities regulations and interpretations. It also breaches an important precept put well by a court in speaking of the Bespeaks-Caution Doctrine:

"The Bespeaks-Caution Doctrine provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away." *In re Prudential Sec. Inc. Ltd. Partnership Litigation,* June 10, 930 F. Supp. 68, 72 (S.D.N.Y. 1996).

When interest rates increase, so will the losses and claims of investors holding fixed income securities who never dreamed that such a loss could befall them.

---

[60] Bond Funds are Running low on...Bonds, Joe Light, Wall Street Journal, May 1, 2013