July 14, 2009

INFLATION IS COMING. WHEN SHOULD WE SELL THE GNMA FUNDS?

QUESTION: Here is my breakeven analysis. Tell me where I am wrong.

I own a bond that is worth $1,000 paying 4.1% interest. I get $41 per year in interest on that bond. If I sell the bond and buy a money market fund, I get 1% interest. That's $10 per year. So I am earning an additional $31 per year with my bond, relative to owning a money market fund that is fully liquid and doesn't have principal risk.

If interest rates rise 10%, so the money market fund is paying 1.1% and my bond should now be paying 4.5%, the value of my bond will decline to $41/.045%, or $911.82. That's a decline of $88, which is more than twice the return benefit I'm getting from having a higher yield at 4.1%. If my goal is to make more money by having this bond than I would in a fully liquid money market, I cannot afford for the price to decline more than $31, which is the difference between a MM yield and my bond yield. And a $31 price decline for the bond is equal to 3%, which is a 7.5% increase in interest rates.

All these calculations are making my head hurt, but here's the key point: If I think inflation is a problem and a small difference in interest rates will make a big difference in bond values, why would I hold on to funds with indefinite maturities and a high leverage factor relative to changes in interest rates? Just wondering,

ANSWER:
Your concept is right but your numbers are off a little. In today's uncertainty, you understand the difficulty in choosing assets when there are conflicts in goals.

- Money market rates are virtually zero (5 bps - .05%)
- Under your scenario, assuming a 10 yr bond, the reduction in value is 3.2% - $32/$1000 bond (discounted present value calculation)

The questions to ask:
1. Are interest rates going higher?
2. Are you willing to take zero interest while waiting to decide if rates are going higher?
3. At what point will higher rates cause losses greater than the interest income received?
4. Where are your loss limits before you no longer wish to continue holding the GNMA fund?

Your questions are perceptive.

Thus far, the GNMA fund strategy has worked, and rates have fallen instead of gone up. Mostly, we have profits in the GNMA funds (plus the dividends). I am willing to give up the profits but not the dividends. The Treasury (10 yr) at 4% is about where that crossover occurs.

Does this help?