My Favorite Bond Fund For The Next 15 Years

March 15, 2019

This Letter is an excerpt from a Premium Edition Letter that was originally published on February 12, 2019.

Interest rates have begun an upward long-term trend

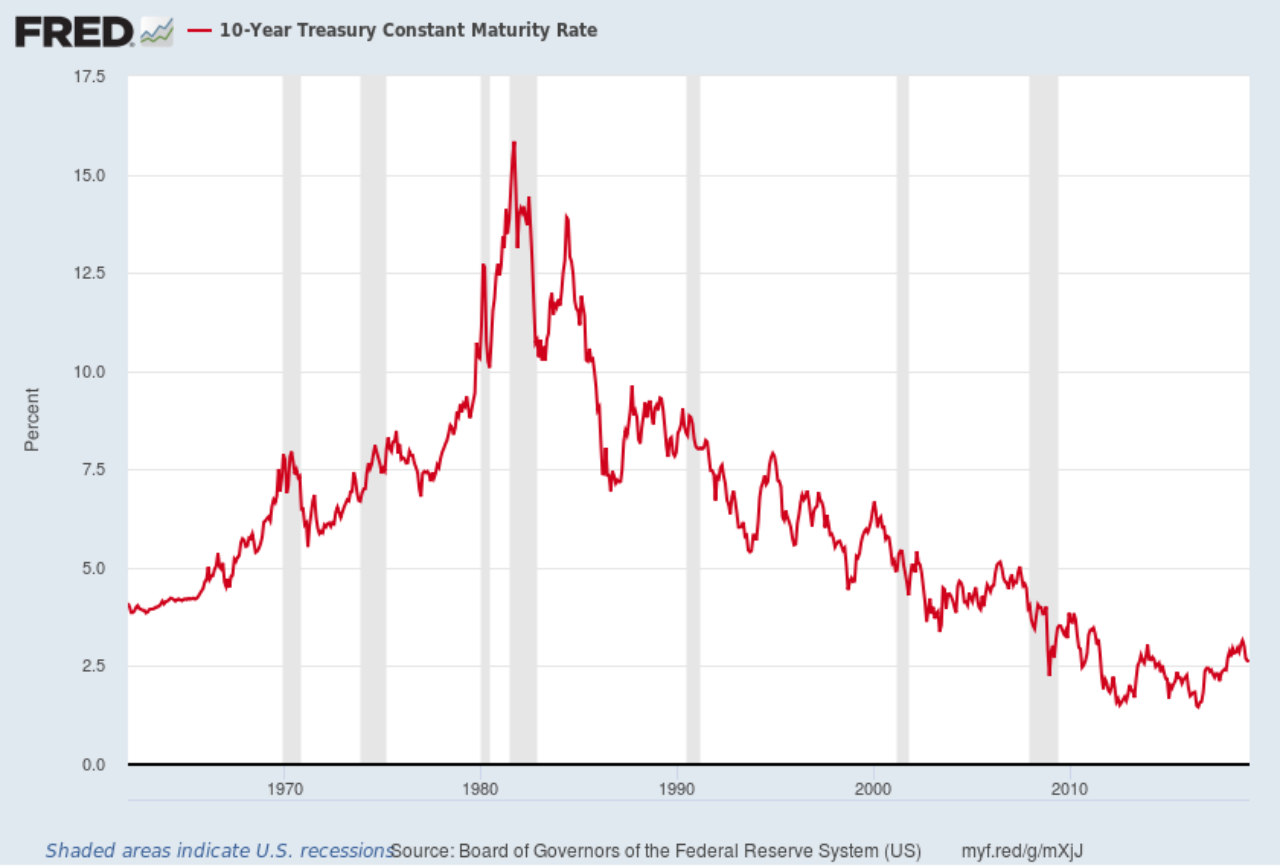
My long-term views on interest rates and the bond market are:

- Interest rates are going to continue to rise, albeit with strong countertrend rallies that could sometimes last several years.
- Higher quality corporate bonds will outperform government bonds due to the extreme levels of government indebtedness and general fiscal mismanagement (at least in the United States).

The following **monthly** chart of the 10-year US treasury bond goes back to the early 1990s:

courtesy of barchart.com; double-click to enlarge

And here is the **daily** chart of the 10-year US treasury bond going all the way back to the early 1960s:



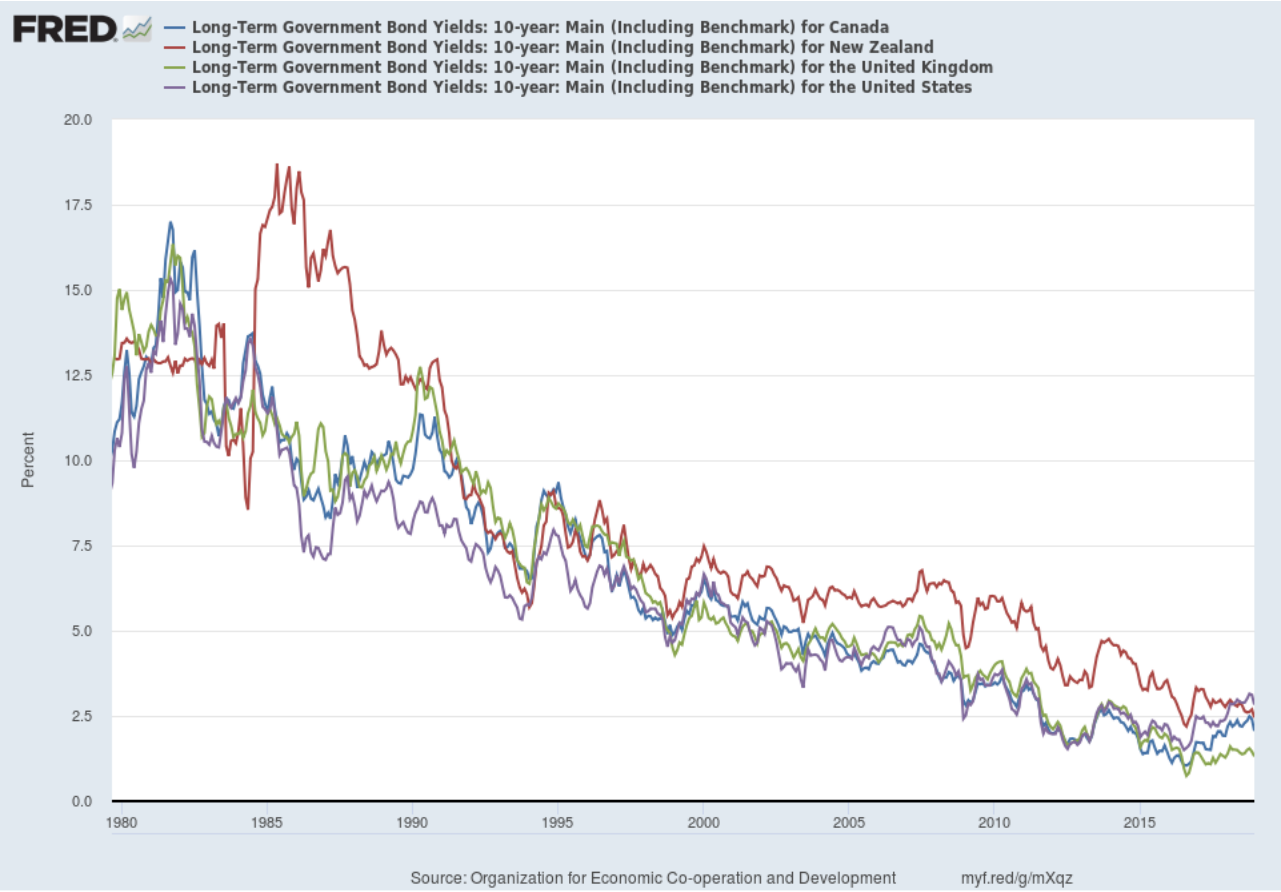
double-click to enlarge

It is my view that the 10-year US treasury bond broke out of its 35 year downtrend in early 2018 and is now on a long-term trajectory that will see interest rates gradually climb higher.

The primary issue at hand is that the US is running a budget deficit close to $1 trillion, interest on the debt is closing in on $400 billion per year, and the Federal Reserve is still on pace to let $360 billion of treasuries roll off its balance sheet in 2019 which is the same thing as saying the Fed will be selling $360 billion of treasuries in 2019. Altogether, we are looking at roughly $1.76 trillion of additional US treasuries that the market will need to buy in 2019. Assuming supply is greater than demand, interest rates will have to rise to encourage more buyers. I expect we are now closing in on another move higher in interest rates. Looking at the first chart above, I see a 10-year bond yield that is ready to make its next move higher.

It is important to understand that US treasury bonds are viewed by the professional investment community as a sort of benchmark for all bonds (mortgage backed, corporate, etc.) so, in general, if treasury rates are rising, then the yields for other US

bonds are also going to be rising. Furthermore, this will tend to put upward pressure on all developed market government debt. The following chart compares the 10-year US treasury yield to the 10-year government bond yields of some countries where subscribers currently reside:



double-click to enlarge

When I write that I am expecting to see US interest rates continue to rise over the coming years (and decades) this means that developed market interest rates will be rising globally. This last chart makes this correlation perfectly clear.

3 things to look for

As interest rates continue to climb higher this will put added pressure on the most indebted companies. Because of this, I have no interest in high yield or "junk" bonds. I want quality and I do not consider government debt to be quality either.

This leads me to look for 3 distinct qualities in a bond fund investment:

- **very short maturities (duration) and/or variable rate**
- **good balance between high quality corporate & mortgage debt and yield (a small amount of government debt is okay)**
- **low expense ratio**

This focus essentially isolates my risk to underperformance in the event that I am wrong and interest rates are still on a long-term downward trend. This is a risk I am willing to take.

What to avoid

What I absolutely do not want to do is own a longer duration bond mutual fund in the early stages of a long-term rate rising cycle. If rates spike higher, this can result in permanent losses of principal if the fund manager is forced to sell bonds in the face of investor redemption requests.

Bonds mature at par which is usually $1,000 for each bond. If the fund owns bond at an average price of $1,200 and interest rates spike higher, the average price of the bonds in the fund could fall to $900. The bonds will eventually mature at $1,000 and will continue to pay interest so investors simply holding on to them for the long-term can recoup their losses. However, if fund shareholders panic and request an excessive amount of redemptions, the manager will be forced to sell bonds at losses. Let us consider a more specific example.

A fund holds higher quality corporate bonds with an average maturity of 15 years and an average coupon rate of 5%. The average price of the bonds in the fund may trade for $1,200 since this would give the fund a yield to maturity of 3.3%. 3.3% is a competitive yield right now given that a 30-year US treasury bond yields a little over 3%. If interest rates increase by 2% the price of the average bond in the fund may fall to $960 since this would result in a yield to maturity of 5.4%. **This is a 20% loss of principal that would take about 6 years to recover given that the fund was purchased when it was yielding 3.3%.** But again, if fund shareholders begin

redeeming *en masse* after such a rate spike, this would result in permanent losses for all fund shareholders.

Invesco Variable Rate Investment Grade ETF

Given the criteria that I have laid out above, the very best fund that I have found after extensive screening and searching is the Invesco Variable Rate Investment Grade ETF (VRIG). Here are the key facts on VRIG as of February 11, 2019:

- SEC 30 day yield is 3.46%
- expense ratio is .30%
- 80.4% of the fund's holdings are rated A- or better (29.8% are rated AAA)
- effective duration = 40 days
- 43% of the fund is corporate debt
- 46% of the fund is high-quality mortgage debt

Most of the fund's holdings are floating or variable rate bonds so if interest rates rise their yields will gradually rise also. This results in the fund having a duration of only .11 years (40 days) which generally means that for every 1% rise in interest rates there would only be a .11% drag on the performance of the fund. Keep in mind that bond prices and yields move in the opposite direction. Rising interest rates are a reflection of the fact that market participants are net sellers of bonds as they demand higher yields to continue to hold their bonds and/or buy more.

Conclusion

VRIG is my favorite bond for the next 15 years. Subscribers outside of the United States may be able to purchase the fund, but should consult the prospectus first. The prospectus will provide information on whether or not non-U.S. domiciled investors can purchase the fund.

Thanks for subscribing to the True Vine Letter.

Joshua

Disclosures:

VRIG is a holding in client & family portfolios. I have an economic interest in the fund.

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