MAKING MONEY WITH BONDS

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OUTLINE

- **WHAT IS A BOND**
- **DIFFERENT TYPES OF BONDS**
- **WHAT DRIVES THE PRICE OF BONDS**
- **THE YIELD CURVE**
- **WHEN TO BUY BONDS AND PROFIT**
- **WHEN TO SELL BONDS AND PROFIT**

(See also Chapter 9 of *Profiting in Bull or Bear Markets*)

BOND FEATURES

- Bond is an obligation
- Coupon
- Maturity
- Price (premium or discount)
- Current yield
- Yield to maturity
- Quality
- Liquidity
- Call feature

WHY BOND PRICES CHANGE

- Interest rates: 10%
- Price of bond: $1000
- Coupon: $100 (current yield=10%)
- Interest rates rise to 15%
- Investors sell bonds to buy higher yielding bonds, until price of bond=$667. Yields now match the market: $100/$667=15%.

WHY BOND PRICES CHANGE

- Interest rates: 10%
- Price of bond: $1000
- Coupon: $100 (current yield=10%)
- Interest rates decline to 5%
- Investors buy bonds to lock the higher yield until price of bond=$2000. Yields now match the market: $100/$2000=5%.

WHY BOND PRICES CHANGE

- Prices change to reflect changes in market interest rates.
- The coupon is fixed. The price has to change to reflect market interest rates.

THE MATHEMATICS OF BOND PRICES

SHORT-MATURITY BOND PRICES

MORE STABLE THAN

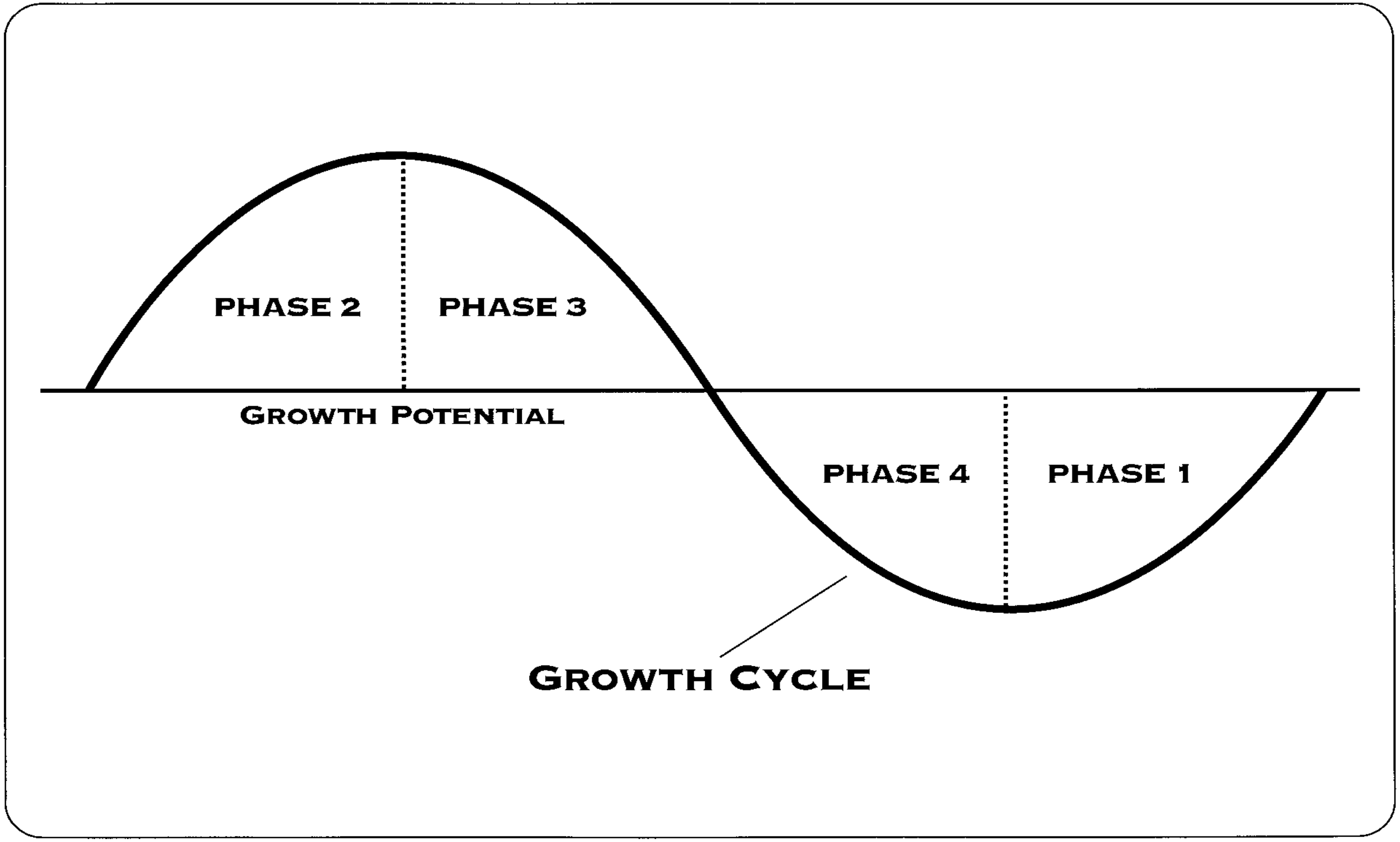
LONG-MATURITY BOND PRICES

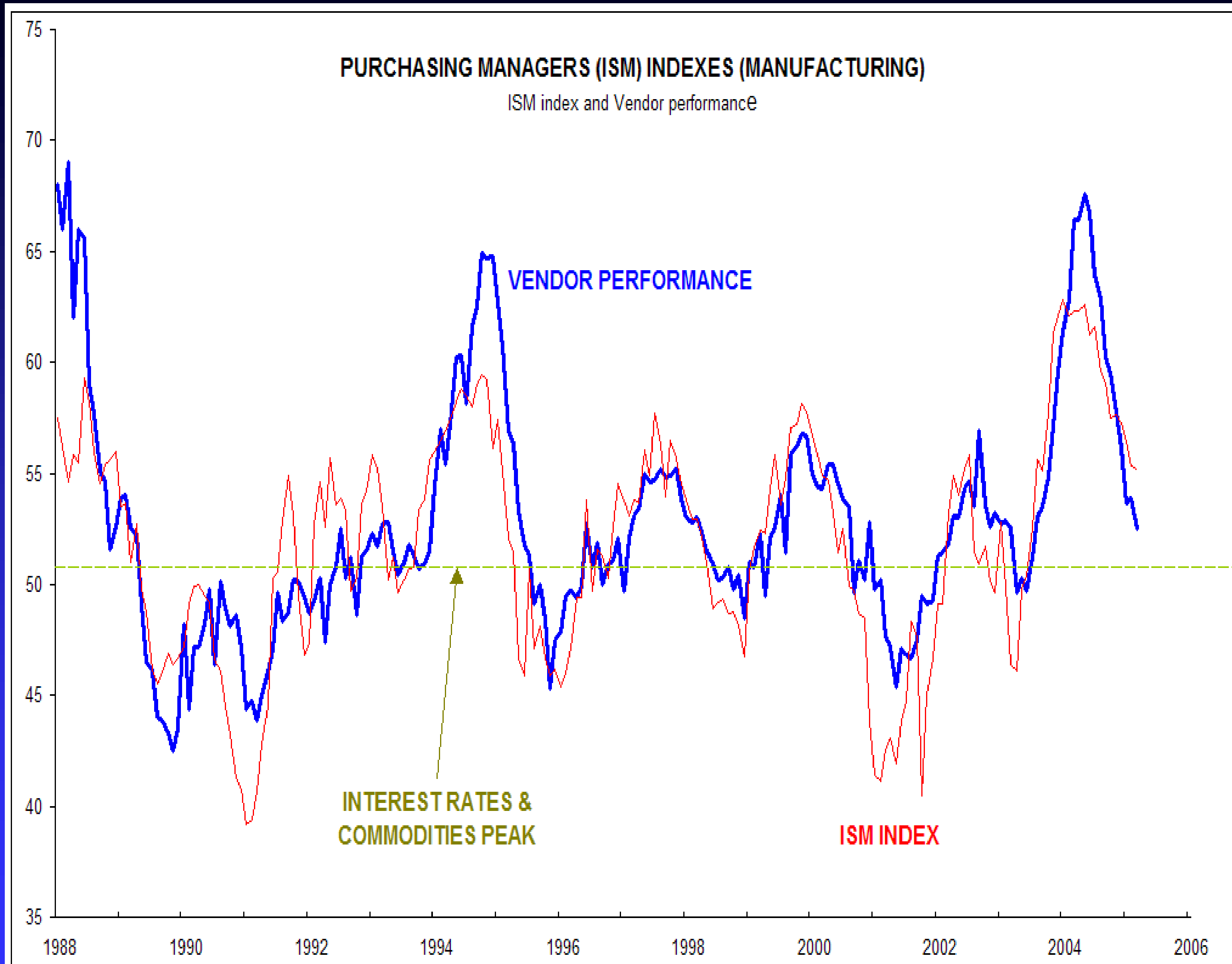
THE MATHEMATICS OF BOND PRICES

- IF YOU HAVE A VIEW ON THE DIRECTION OF BOND YIELDS, USE LONG-TERM BONDS.
- CASH (A VERY SHORT-TERM "BOND") SHOULD BE USED WHEN YIELDS RISE AND YOU DO NOT WANT TO GO "SHORT" BONDS.

THE BUSINESS CYCLE DRIVES INFLATION AND THE NEED FOR LONG-TERM CAPITAL

Business Cycle



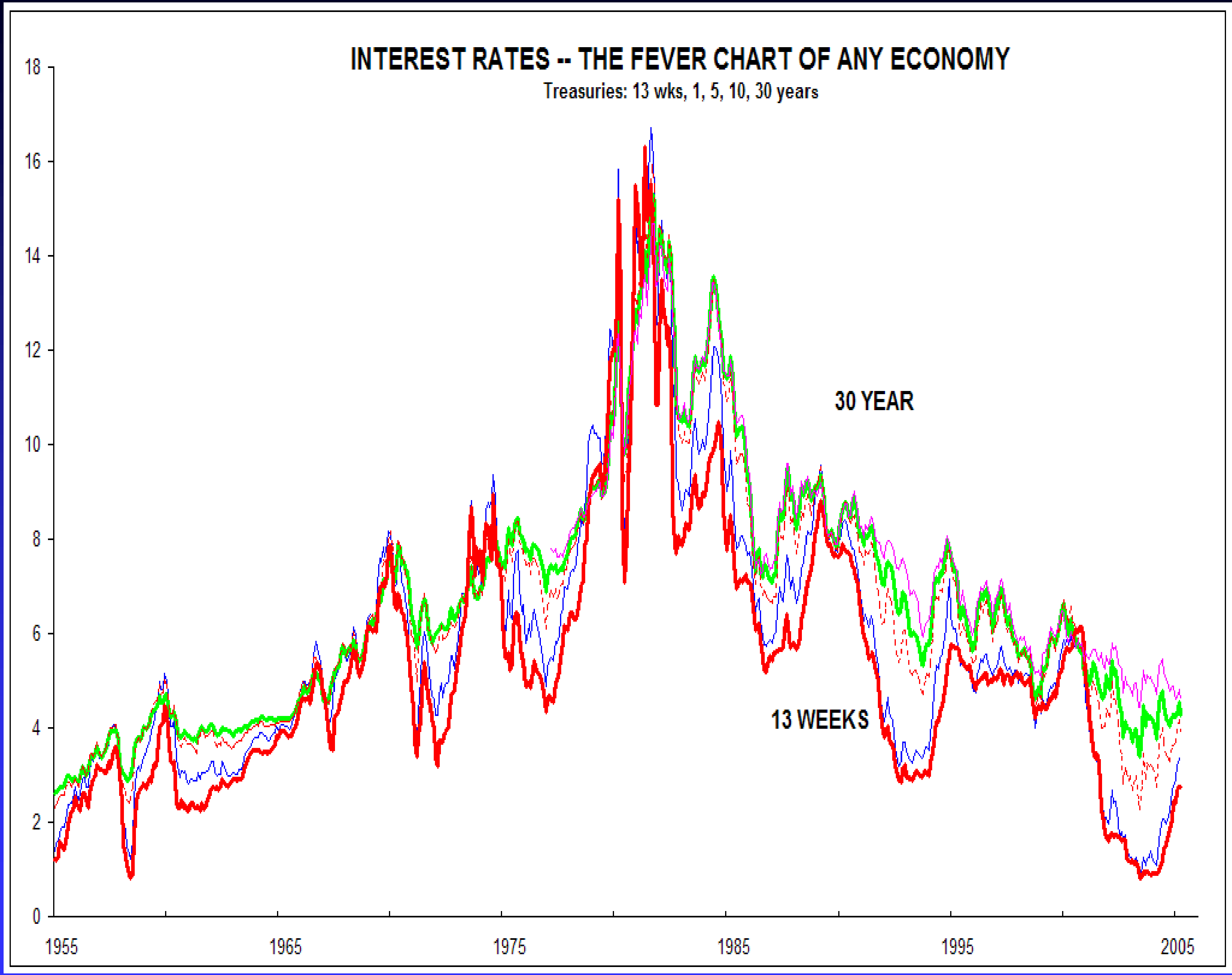

PURCHASING MANAGERS (ISM) INDEXES (MANUFACTURING)
ISM index and Vendor performance
VENDOR PERFORMANCE
INTEREST RATES & COMMODITIES PEAK
ISM INDEX
75
70
65
60
55
50
45
40
35
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006

WHY DO INTEREST RATES CHANGE?

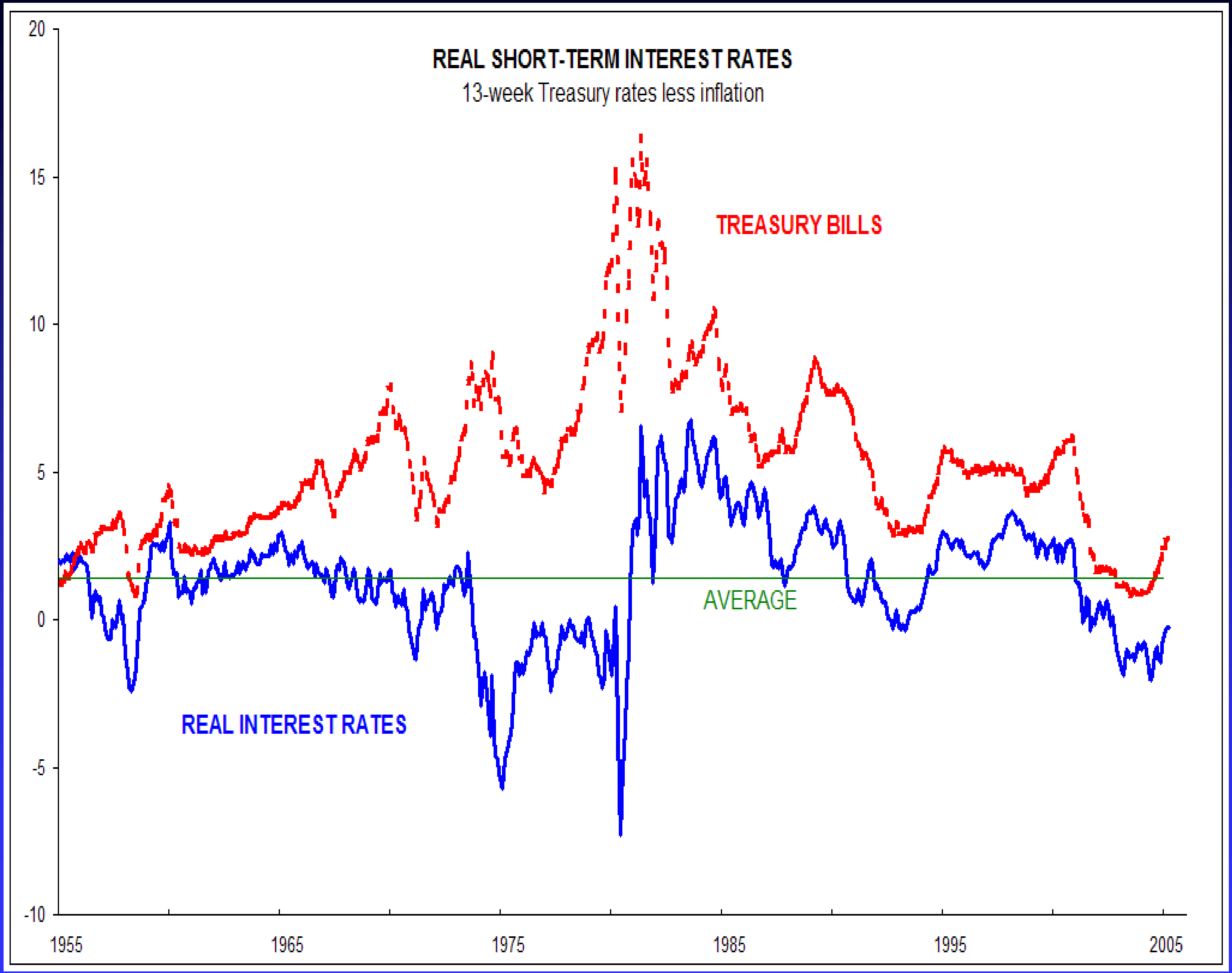
- Lenders want to protect their capital
- Inflation and risk premiums change
  - ✓ Increase when economic strengthens
  - ✓ Decrease when economy weakens

INTEREST RATES: THE FEVER CHART OF ANY ECONOMY

- Too much above 6%: problems
- Too much below 4%: problems



INTEREST RATES -- THE FEVER CHART OF ANY ECONOMY
Treasuries: 13 wks, 1, 5, 10, 30 years
30 YEAR
13 WEEKS
18
16
14
12
10
8
6
4
2
0
1955
1965
1975
1985
1995
2005


REAL SHORT-TERM INTEREST RATES
13-week Treasury rates less inflation
TREASURY BILLS
AVERAGE
REAL INTEREST RATES
20
15
10
5
0
-5
-10
1955
1965
1975
1985
1995
2005

REAL INTEREST RATES

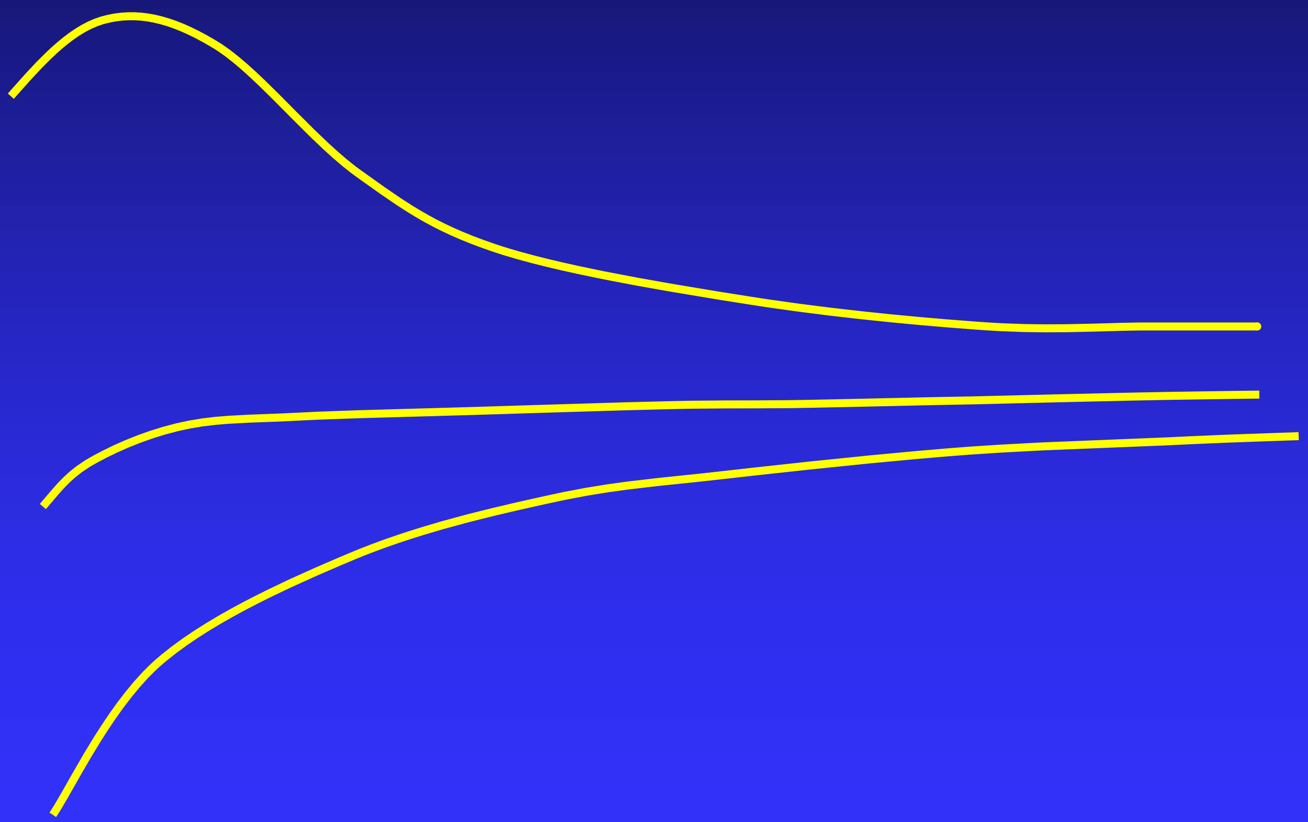
(INT. RATES LESS INFLATION)

- **Inflationary times when less than 1.4**
- **Disinflationary times when above 1.4**

STRUCTURE OF INTEREST RATES

- The relationship between short-term and long-term interest rates changes because short-term interest rates are more volatile than long-term interest rates.
- The relative movement of the two rates is a useful tool to develop investment strategies.

THE SHAPE OF THE YIELD CURVE REFLECTS FINANCIAL LIQUIDITY

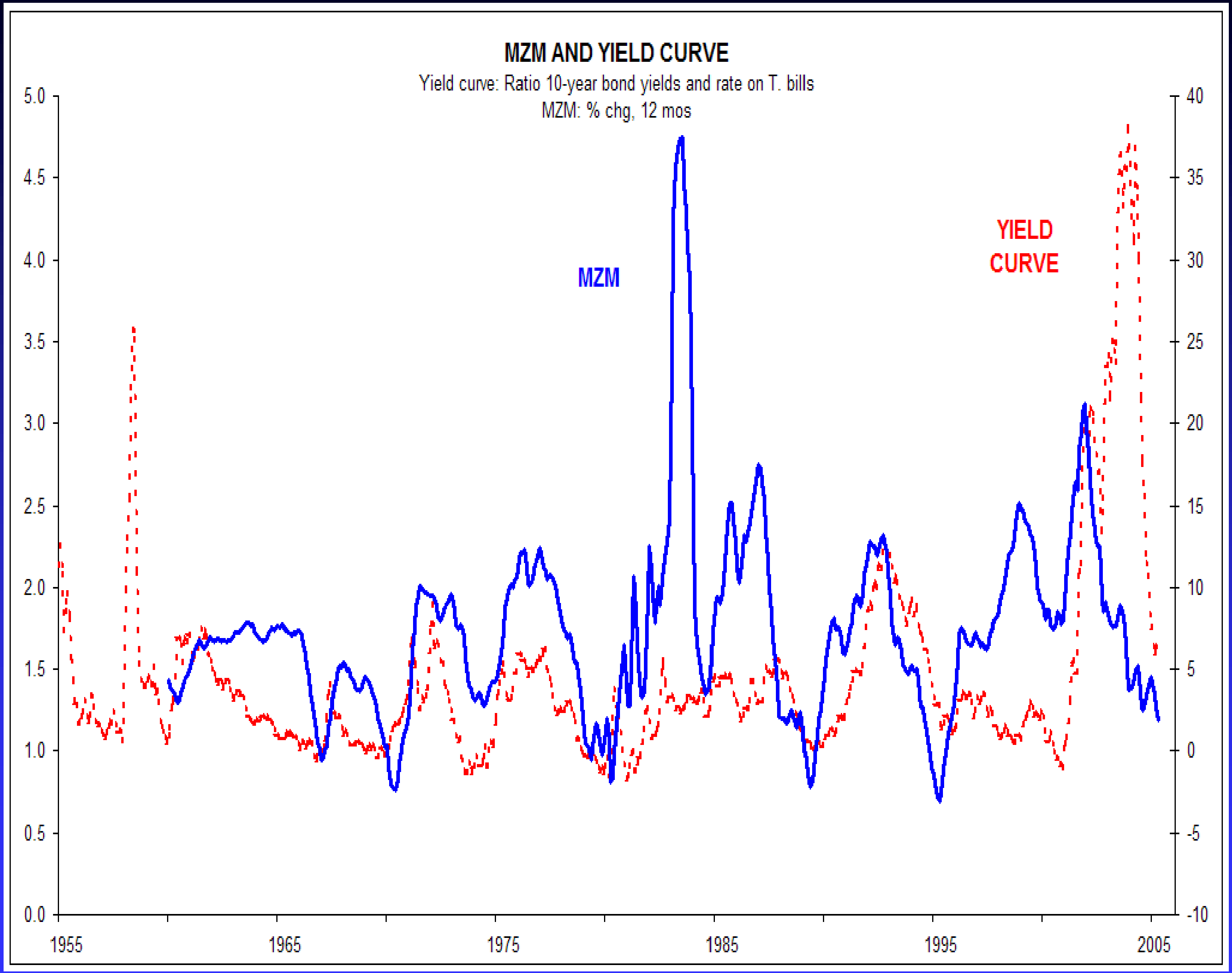


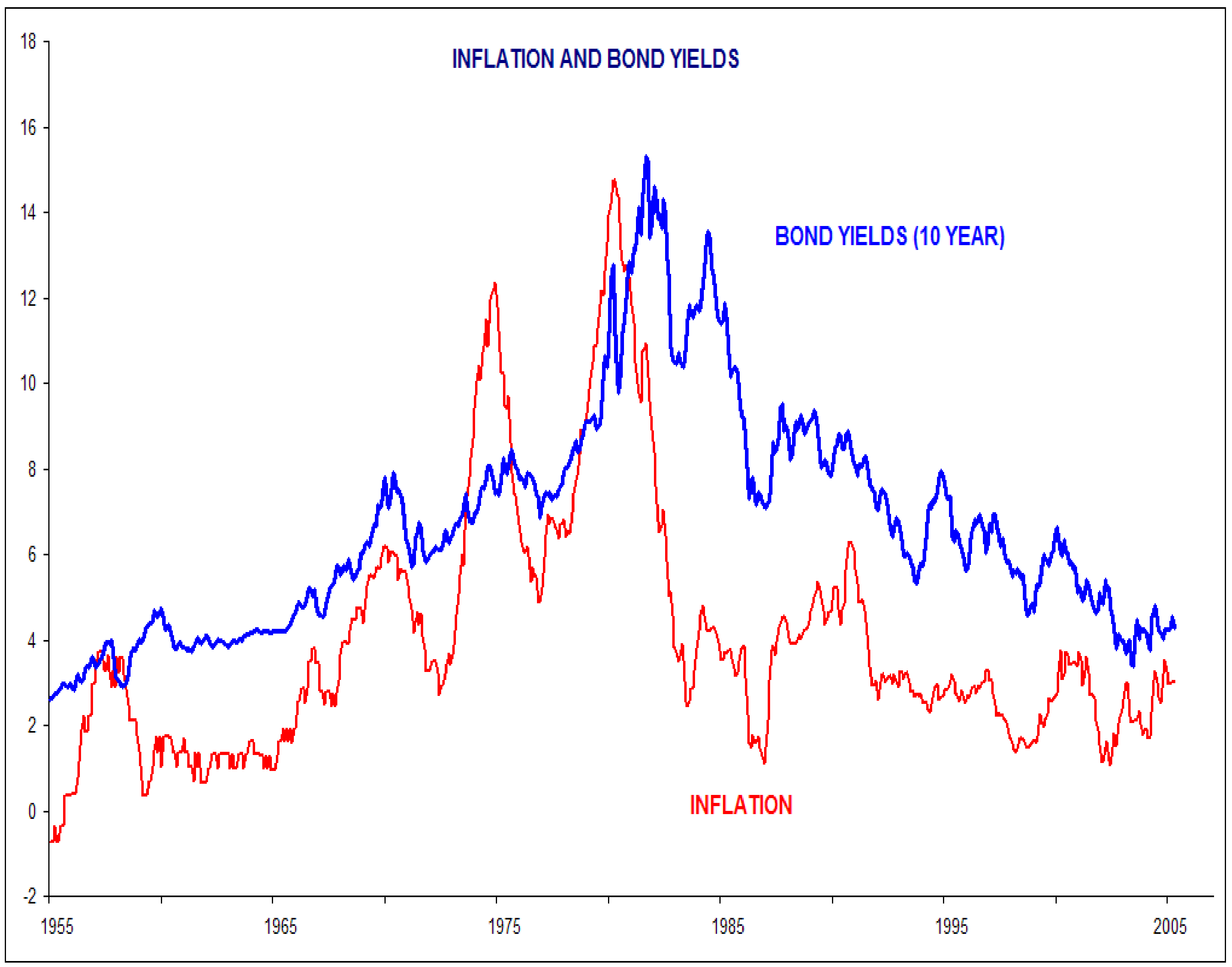
WHAT DRIVES TRENDS OF INTEREST RATES

These are subtle points,

but Wall Street ignores them!

- The strength of the economy drives the trend of short-term interest rates.
- The rise or decline in the growth of the economy drives the trend of bond yields.


MZM AND YIELD CURVE
Yield curve: Ratio 10-year bond yields and rate on T. bills
MZM: % chg, 12 mos
MZM
YIELD CURVE
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
40
35
30
25
20
15
10
5
0
-5
-10
1955
1965
1975
1985
1995
2005



INFLATION AND BOND YIELDS
BOND YIELDS (10 YEAR)
INFLATION
18
16
14
12
10
8
6
4
2
0
-2
1955
1965
1975
1985
1995
2005

BOND INVESTMENT STRATEGIES

- Increase maturity and amount invested in toward the end of Phase 3 and Phase 4.
- Decrease maturity and amount invested toward the end of Phase 1 and Phase 2.
- Buy low-grade bonds in Phase 4 when short-term interest rates decline.
- Sell low grade bonds after short-term interest rates have been rising.
- “Short” bonds in Phase 2 and most of Phase 3 (Rydex-Juno).

DID YOU LIKE THIS PRESENTATION?

I WILL BE DELIGHTED TO MAKE A SIMILAR PRESENTATION TO YOUR INVESTMENT GROUP AND DISCUSS MY INVESTMENT RECOMMENDATIONS

THANK YOU!