Lessons From The Trader Wizard

by Bill Cara

SAMPLE CHAPTER:

Part 2: CARA'S APPROACH TO TRADING BONDS, BOND FUNDS AND CASH

I began this part of the original book as follows:

The economic problems the Administration does not want to address are widespread. Higher energy, food and mortgage costs will break the budget of many Americans this time around. We are in a transitioning phase where bonds will become more attractive than stocks for a while. After stocks start to fall, "The Fed" will drop the interest rates and bonds will start to rally. However, the momentum of falling stock prices will linger, and that is the time it will pay to be out of stocks and into bonds. — from Bill's blog

Eighteen months later, the most popular US Treasury Bond for traders, the 20-year TLT, had soared +49% while the S&P 500 benchmark equity index had plunged -41%. I refer to these results as 'proof of concept'.

1. What is a bond?

You can't become a successful trader of stocks until you understand a little about the bond market. Because bond yields and interest rates work in combination, together they drive stock prices.

When you buy a bond, you are lending your money to a corporation or government. In return, you receive a certificate or contract that states the issuer will pay you interest at a specified rate — usually twice a year — until the principal debt is repaid, sometime in the future; perhaps 10, 20 or 30 years hence.

When most people buy a bond or "debenture", they do so for income or security. Somebody else's obligation or debt is the buyer's asset — just like a stock except the owner of a bond doesn't hold any equity in the business. The asset is limited entirely to the debt, which underscores the importance of the contract.

To many of you, a bond is a secure, mostly stagnant holding that provides a fixed annual income and can be redeemed at maturity for the same amount of dollars used to buy it. There are risks with all kinds of bonds as well as opportunities to attain capital gains or to increase total returns from income plus appreciation.

Thus, it's important that bond traders understand the agreement.

The type and quality of the debt is a prime concern to the trader. A bond is secured debt, whereas a "debenture" is unsecured debt. A bond may also have other features, like convertibility to stock.

The bond agreement will contain a security clause, while in the case of a "debenture" there is no such security. Hence, bonds are typically more secure than debentures, but not always. A bond issued by Consolidated Moose Pasture is not as secure as a "debenture" from McDonald's. As many traders discovered to their chagrin in 2011 and through to the present (June 2012), however, even the sovereign bonds of major economic powers like Italy and Spain are not secure.

Clearly, the financial strength of the corporation or government is a significant factor in determining the quality of the debt.

A straight bond is usually priced relative to the current cost of money, which is reflected by the interest rate, which for the most part is set by central banks. Capital gain opportunities result from changes in central bank policy and in the interest rate market.

How interest is calculated and paid

Interest on bonds is calculated on a daily "basis" and added to the sales price (but does not include the day of delivery). For US Government issues other than "Treasury Bills", the base is the exact number of days in a 365-day year. With other bonds, it's a 360-day year or 12 30-day months.

To figure out the "yield" superiority of 360-day bonds (versus 365-day bonds), divide the interest rate by 360 to get the daily return, then multiply the result by 365. With a 12% interest rate, the daily rate works out to 0.333%, so the annualized rate for 365 days would be 12.16%.

How bonds are rated

General description	Moody's	S&P
Best quality	Aaa	AAA
High quality	Aa	AA
Upper medium	A	A
Medium	Baa	BBB
Speculative	Ba	BB
Low grade	B	B
Poor to default	Caa	CCC
Highly speculative to default	Ca	CC
Lowest grade	C	C

Ratings may also have a + or - sign to show relative standings in the class.

Prices for high-grade bonds — rated A or better — reflect money-market conditions and interest rates almost exclusively.

The lower the rating, the more the bond prices are more closely attuned to business conditions generally, and to any changes in the quality of the issuer.

Medium-grade Baa or BBB bonds are the lowest category that qualifies for commercial bank portfolios.

Any rating of Ba or BB or lower is speculative and traders should not buy these bonds without analyzing current financial statements and considering the industry prospects. Of course, if you want to speculate, corporate Ba or BB-rated bonds were paying over 8% and B-rated junk bonds 10% or more in 3Q07 at the time of the original book, and that's close to the market today (June 2012).

Differences in bonds

Quality

Unless you are day trading interest rates, you ought to be buying bonds for safety. Stick to high- quality issuers and forget the small amount of extra interest ($5 to $10 per year per bond) that can possibly be obtained with the debt of a company that has a dubious credit rating.

Most corporate and municipal (but not Federal Government) bonds are rated by statistical services in nine categories from gilt-edged to extremely speculative. These ratings represent carefully calculated estimates of the degree of protection for both principal and interest, based on past performance, current financial strength and future prospects.

Collateral

This is the property that stands behind each bond. Secured bonds may be:

- First-mortgage bonds backed by the company's real estate, plants, heavy trucks and so on, or equipment trust certificates such as the ones secured by railroad locomotives, freight cars, etc.

- Bonds guaranteed, according to principal and interest, by another corporation or by the government or a government corporation or agency. Examples of the former are foreign bonds offered for sale abroad by foreign subsidiaries or affiliates of US corporations and guaranteed by the parent company.

Unsecured bonds (debentures) are backed only by the general credit standing of the issuing company. The trader should translate this credit into the company's ability to pay annual interest and amortization plus the principal sum when due. The projection should consider recent historic ratios and trends, and should apply to the total debt. In practice, for most bonds, the ability of the corporation to pay is much more important than theoretical security, because legal obstacles to traders collecting a bond's security due to insolvency are formidable and time-consuming and often require litigation, which is the last thing you need in your life.

If an industrial bond is unrated, a rule of thumb for determining investment-grade is that interest charges should be covered over a period of five years at the following rate:

Bonds of:	Before Federal Income Taxes	After Federal Income Taxes
Industrials	5x	3x
Transports	4x	3x
Electric, gas and water utility	3x	2x

Serial and "sinking fund" bonds

Serial bonds are issues redeemed at various dates over a period of years. This enables a buyer of a new bond to select the exact maturity desired: say, in 10 years when a son or daughter is due to start college. Usually, all the debt comes due at once but a "sinking fund" feature means extra safety.

Bearer or registered bonds

Historically, most bonds were issued in bearer form with interest coupons attached. Interest was paid, usually twice a year, by presentation of the detachable coupons to the paying agent. This is the origin of the phrase "clipping coupons".

In today's world of forgeries and scams, do not deal in bearer bonds and only buy unrated bonds from a topflight broker-dealer who is a known bond trader.

Exchange-traded bonds

Bonds, like stocks, even trade on the "New York Stock Exchange" (NYSE), which operates the largest centralized bond market of any US exchange or other self-regulatory organization. A list of current bonds traded on the NYSE is available at: http://nysedata.com/bondsymbols.

The NYSE offers a broad selection of over 2,000 corporate (including convertibles), agency and government bonds and even foreign bonds. Most bond volume at the NYSE is in straight domestic corporate debt, with some 15% in "convertible bonds".

In my opinion, the NYSE website is outstanding in many respects. For trading bonds, you'll find all the information you need at: http://nyse.com.

NYSE-listed bonds trade through the exchange's Automated Bond System (ABS), a terminal-based system for trading corporate, agency and government bonds. The ABS system maintains and displays prices and matches price orders on a price and time priority basis.

ABS reports real-time quotes and trades to market data vendors. Closing bond prices are available in the financial sections of major newspapers, as well as on-line.