

Gaining From Bond Coupons If Rates Rise

Now that strong and continuing commodity trends are back in style, it may be instructive to revisit an analytic technique from one of the pioneers of breakout trading, a real *trendo di tutti trendi* amongst the early commodity trading advisors, Richard Dennis. He would have his assistant present him with charts each and every morning with no axis labels or titles; this was in the days when charts often were still done by hand or when traders updated a weekly subscription service chart by hand.

The idea was simple: By not knowing what the market was or over what time frame it was being presented, Dennis had to rely solely on his analysis unencumbered by the baggage of his positions or (shudder) by fundamental claptrap. I later used this on a group of charts for the take-home final in a market analysis class I taught and asked students to give me their short-term forecasts and positions for those markets. By and large, they did pretty well on it and enjoyed it thoroughly.

So, given that windup, would you buy or sell the market depicted below? I have taken the liberty of drawing in a couple of trendlines, a downward sloping channel and an ascending support line that appears to be forming a large pennant with the top line of the channel.

Buy Or Sell?

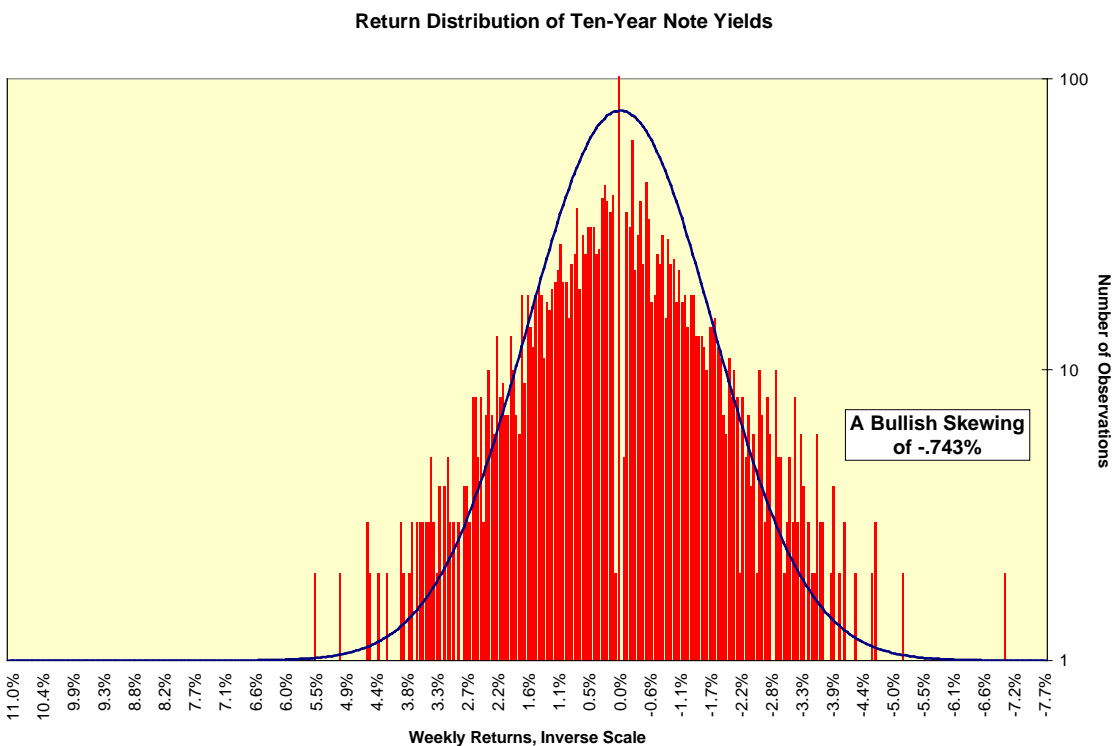


If we accept the dominant feature of the chart as the massive reversal higher midway through the time scale, a feature that remains unchallenged, then the ascending support line and the series of lower highs in the channel should be a bullish pennant. This thesis would be proven wrong very quickly if the ascending support line is broken, and the whole outlook would change to a massively bearish chart should the lower bound of the channel be violated as well. In that case, a challenge of the chart low should be expected.

Going To Take You Higher

The chart itself is the yield on ten-year notes over the last trading year. A realization of the bullish chart interpretation projects yields of 5.40% fairly quickly. And, oddly enough for stock traders conditioned to seeing prices falling faster than they rise, a retest of the 3.07% level hit last June could happen even more quickly given any sort of shock. The weekly "returns" on constant maturity ten-year note yields as compiled by the Federal Reserve since 1962 have a negative skewing, or distortion of the expected bell curve from symmetry around zero. This, and

the greater effect on note prices for a given drop in yields as opposed to an equal rise in yields means that note prices rise more quickly than they fall.

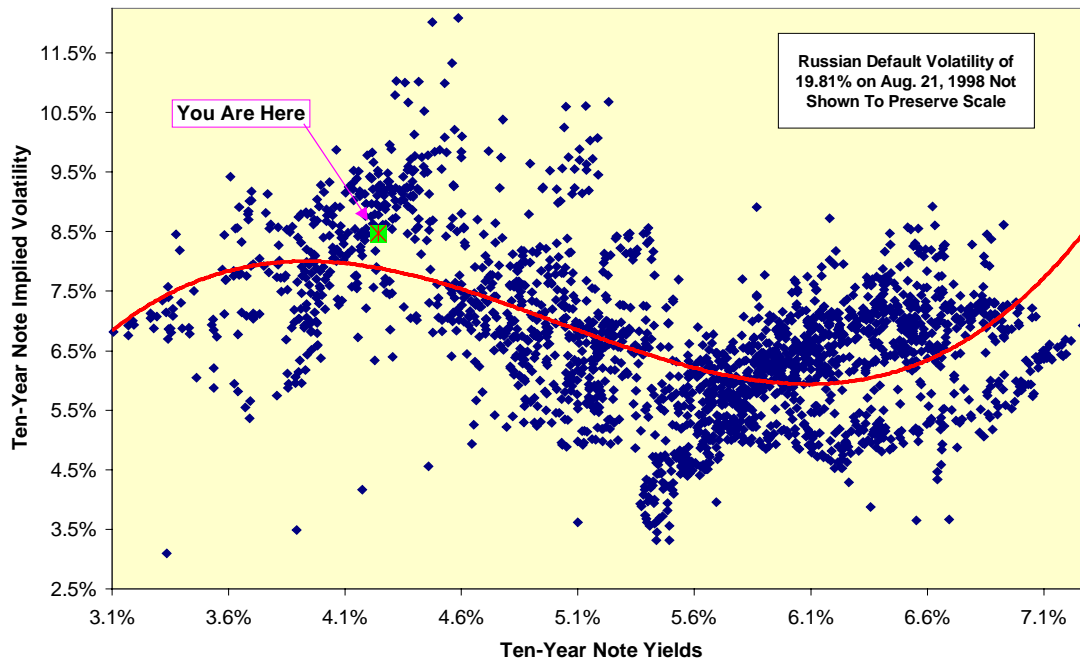


Congenitally fearful bond traders, who never want to be the first kid on their block to buy anything, might be quite surprised at their own audacity as implied by the data. And we all thought they had the Beatles' *Dear Prudence* on a continuous tape loop in the office.

Playing The Rate Outlook

Markets trade in dimensions other than price; in the case of Treasury notes, these include the shape of the yield curve and implied volatility. The relationship between yield and volatility in notes is far more complex than the relationship between stock prices and volatility. Volatility can surge during both fight-to-quality buying panics and during bond market selloffs of the kind seen this past summer. But, given the experience since 1995, we should expect to see a gradual decline in volatility given an orderly increase in yields.

Will Rising Yields Lower Volatility?



Adding The Interest And Dividend Angles

There are numerous ways to go short notes, including selling futures, buying puts on futures, shorting individual bonds, buying negative-beta bond funds such as Rydex' Juno or ProFunds' Rising Rates Opportunity, or borrowing money yourself at fixed rates. All share a common characteristic, and that is the seller has to pay the coupon stream, which can constitute a significant holding cost over time. In addition, with the exception of buying put options, none of these strategies have a limited downside.

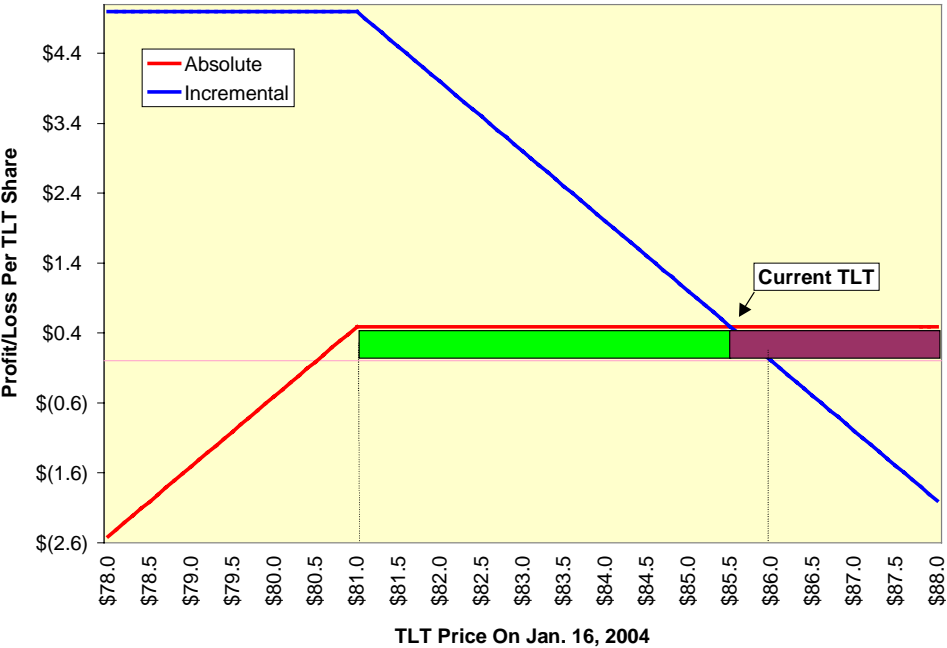
Bonds trade with accrued interest, and we do not expect the price of a bond to fall the way a stock does when it trades ex-dividend. This is not the case, however, for the fixed-income ETFs, such as the iShares SHY, IEF and TLT for short, intermediate and long-term Treasuries, or the LQD described [here in June](#) for corporate bonds. These ETFs accrue their constituent bonds' coupons and pay them out monthly as a dividend; the ETFs' prices then trade ex-dividend like a stock. These dividends are not eligible for the 15% tax treatment of qualified stock dividends as they derive from bond coupons and not corporate earnings; they are taxed at ordinary income rates.

All of this creates an opportunity to capture the ETF's dividend along with the implicit loan income (time premium) of an in-the-money short call option on the ETF at the risk of a significant short-term jump in interest rates. If these trades are emplaced in a retirement account, as is recommended strongly, the ordinary income taxes on both the ETF dividend and the short call option can be deferred.

Let's take the case of the TLT, which will both announce its exact dividend and start trading ex-dividend on December 31, 2003; the dividend should be on the order of \$0.40 per share for an annualized yield on this (December 12th price) \$85.51 stock of about 5.61%. Long-term support on the TLT, based on its August lows when long-term rates were about 35 basis points higher than today, should be near \$81 per share. A January \$81 call went out at \$4.50-4.70, which represents a time premium of about \$0.10 per share - the bid on the January \$81 put - and the expected drop in the TLT price on December 31st when the stock starts trading ex-dividend.

The net of the trade at expiration can be depicted below. The absolute return of the trade will not exceed the dividend plus net time premium received, and should interest rates surge and the \$81 support level be broken, the return will be negative below (\$85.51 - premium received). If the TLT price goes over (\$85.51 + dividend + time premium), you would have been better off simply owning the TLT, but at any price below this level, the long TLT/short call option combination is superior.

Absolute & Relative Trade Gains



While the gains on such a trade may look as if they do not justify all of the moving parts, consider that the annualized gain shown above is 7% gross. If this is done in a retirement account, the gain jumps toward 10.8%, near the long-term average gain on equities, and that is before the application of any state tax savings. The risk is no greater than the risk of owning the fixed income ETF outright.