Does U.S. Stand For Un-Suitable?

Every Series 7 registered representative has to operate under the “know your customer” rule, which means, amongst other things, they have to recommend investments suitable for their customers. The whole concept of what is suitable is very fluid and gets defined, more often than not, after the fact by an arbitration panel. Some cases are obvious, such as putting the proverbial grandma into an option-writing program, but most are not.

Let’s put our thinking caps on and ask whether the security class long taken as the definition of suitability, U.S. Treasuries, are approaching or already have exceeded the limits of suitability. Let’s start out with the current five-year Treasury, the 1.50% due July 31, 2016. All data used below are real-time from the morning of Thursday, August 18, 2011.

The note is at 103.015625. This premium over par means your yield to maturity must be less than the 1.05% coupon yield; it is 0.8759%. As expected inflation, derived from the TIPS market is 1.656%, you are receiving a negative expected yield of about -0.78%. This is before taxes, if you are holding this in a taxable account.

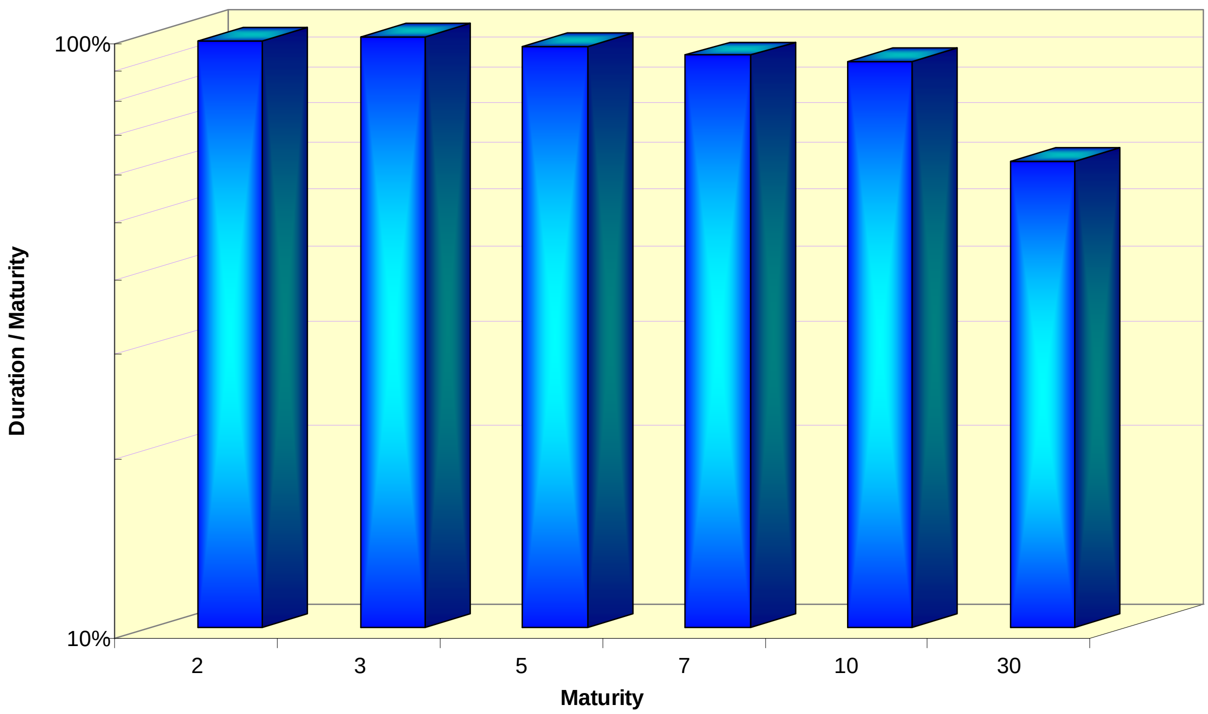
The duration on this note is 4.76. While you are likely to receive that par payment five years from now, at least in nominal terms barring an actual and not a threatened default by Uncle Sam, consider what would happen if you bought it and decided, for whatever reason, to sell before maturity. That duration means you would lose 38 months of coupon income for a 100 basis point rise in yields. This is hardly beyond the realm of possibility; the five-year Treasury was 100 basis points higher in May.

The conclusion is very similar for the ten-year Treasury. Here the 2.125% note due August 15, 2021 is priced at 100.273 for a yield to maturity of 2.094%. The ten-year TIPS breakeven rate is 2.063%, so expected real yields are a positive 0.031%. Do not spend this all in one place; by all means diversify.

The duration here is 8.95, which means you would lose more than 50 months of coupon income for every 100 basis point increase in rates should you want or need to sell the note. We were at those yield levels in early July.

Duration rises as yields fall; at the limit, the duration of a zero-coupon bond is its maturity. As I pointed out recently in reference to corporate bonds, the greater the ratio of duration to maturity, the riskier the bonds are and, by definition, the less suitable they are to a larger class of investors. Here is a chart of the duration-to-maturity ratios for current Treasuries:

Treasuries Approaching Zero-Coupon Status



Now let's apply the Dirty Harry test to see whether a registered representative feels lucky: You can recommend the securities of an issuer trillions of dollars in debt and that just added another $2.4 trillion to the pile, was downgraded albeit clumsily by one ratings agency, has an unimaginable unfunded liability, is printing money like there is no tomorrow and will have to revisit its fiscal situation after the next election. Those securities both have an expected negative real yield or one that is just barely positive and are starting to act like zero-coupon bonds.

Five shots or six? That we can ask this question tells us how far we have fallen.