NCM Client Notification

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Bond Opportunity Results

Yesterday we sent a Client Notification explaining that we have been finding what we consider generational bond buying opportunities due to the unprecedented flight to quality, and asked that any interested clients contact us. Below is a more detailed explanation of the situation:

Bonds are typically issued in increments of $1,000. Companies seeking to raise funds sell bonds to investors. Simply speaking, bonds are loans from the investor to a company. Terms on these loans are like most others in that the company has to pay a certain rate of interest, and unlike most loans we would take out personally, the entire principal is due at a certain date (referred to as the maturity date). For example, if issued by GE a bond description might read 4% 10-2-2009. Under the terms of this loan GE would pay us 4% interest ($40 per bond for the next 12 months) with a lump sum payback of $1,000 on 10-2-2009.

After the initial offering, these same bonds will be bought and sold amongst investors in the ***secondary market***.

Prices in secondary transactions are influenced by a variety of factors. They include the current interest rate environment, business conditions, inflation and sentiment. Presently, the sentiment factor has created a shocking disparity between what bonds should be worth and what they are trading for.

Going back to our example using the GE bond, in a stable interest rate environment where the economy is doing well, the bond may trade for close to the $1,000 initial value and maturity value. However, if sentiment is such that investors are concerned about the viability of GE, they may offer substantially less than $1,000 for the bond. So the situation could look like this…

Because of concerns about GE we are able to buy the 4% bond for $800 (a $200 discount to the known maturity value of $1,000 on 10-2-2009). We will collect the 4% interest or $40 over the next 12 months, at which point the bond matures and GE pays us $1,000. Therefore, the “return” on our investment was the $40 interest plus $200 appreciation for a total of $240, or a whopping 30%.

Obviously, the critical factor is whether or not GE survives for the year to make good on the loan payoff. Bonds of the companies cited below are all A-rated or better. The ratings scale runs from AAA to D, with anything BBB or above considered “investment grade”.

The names may scare you, as many have been associated with the most recent financial crisis. However, with passage of the financial support bill in the House, we feel these companies will survive for the short windows of time we will have exposure... and well beyond.

This strategy is not for everybody, and there are various levels of risk. Below we have listed possible bond issues being offered at this moment on the secondary market. Please note this is not a complete or exact list of what we would purchase in your account, but simply designed to provide you a sampling of the types of bonds we would use. Inventory is constantly changing, as are yields.

- Capital One Bank Notes - estimated annualized yield to maturity 24.62% - maturing 12/1/2008
- Morgan Stanley Notes - estimated annualized yield to maturity 20.16% - maturing 1/15/2010
- TransAmerica Debentures - estimated annualized yield to maturity 10.18% - maturing 3/1/2010
- CitiGroup Global Note - estimated annualized yield to maturity 9.38% - maturing 3/1/2010
- Merrill Lynch Notes - estimated annualized yield to maturity 8.965% - maturing 8/4/2010
- Hartford Financial - estimated annualized yield to maturity 8.055% - maturing 6/15/2010
- Morgan Stanley Notes - estimated annualized yield to maturity 16.17% - maturing 4/15/2011
- Key Bank - estimated annualized yield to maturity 14.76% - maturing 2/1/2011
- Capital One - estimated annualized yield to maturity 10.55% - maturing 9/15/2011
- Morgan Stanley - estimated annualized yield to maturity 16.99% - maturing 4/1/2012
- Key Bank - estimated annualized yield to maturity 11.16% - maturing 8/15/2012
- Genworth Financial - estimated annualized yield to maturity 11.14% - maturing 6/15/2012
- Citicorp - estimated annualized yield to maturity 10.21% - maturing 10/15/2011
- Hartford Financial - estimated annualized yield to maturity 9.816% - maturing 10/15/2011
- GE Capital - estimated annualized yield to maturity 6.916% - maturing 2/15/2012

As you can see, the distortions in the bond market are creating some amazing yields. We held our search to around four years to maturity.

If you have an interest in having us purchase some of these issues in your account, you now need to confirm that intent. We will cap exposure to 5% of assets under all circumstances and diversify as best we can within that 5% to minimize company risk. Please contact our Trading Specialist, Molly Chase, at (509) 456-2526 ext. 24 or molly@ncm-inc.com.

Northern Capital Management, Inc.
Investment Committee