CONSUELO MACK | WEALTHTRACK

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On this week's show, top rated bond fund manager Jason Brady, CEO of Thornburg Investment Management explains why he currently favors dividend paying stocks over bonds!

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CONSUELO MACK: This week on WEALTHTRACK, like any global competition the search for income requires dedication, discipline, analysis, precision and skill to succeed. Highly rated bond fund manager, Thornburg Investment Management's Jason Brady discusses his strategy next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
Question: What's the one investment that Wall Street prognosticators have been telling us to avoid for years because they are overpriced and thus risky? The answer is bonds. The conventional wisdom has been that interest rates can't possibly remain this low for long and that sometime soon the Federal Reserve will start a series of rate hikes to get them back to normal levels, whatever they are. Even the Fed has encouraged this assumption.
Suprisingly, investors have not paid much attention to these warnings.

With few exceptions investors have continued to pour money into bond mutual funds and ETFs since the financial crisis. For the most part it has been a very good decision. Despite expectations to the contrary the three decade plus bull market in bonds is largely intact. Investors might be getting lower yields but in the fixed income world that means prices of bonds go up.

This week's guest, Jason Brady manages several highly rated funds for Thornburg Investment Management where he was recently named President and CEO in addition to his duties as Head of the firm's Global Fixed Income Investment Team. He runs multiple portfolios at the firm, including Thornburg Limited Term Income Fund, Strategic Income Fund and the fixed income portion of the Thornburg Investment Income Builder Fund where Brian McMahon runs the equity side. Brady is also the author of Income Investing: An Intelligent Approach to Profiting from Bonds, Stocks and Money Markets.

Thornburg is a WEALTHTRACK sponsor, but given Brady's record we will not hold that against him.
I began the interview by asking him is there any reason to believe the bull market in bonds is coming to an end anytime soon?

JASON BRADY: I just think it's a question of time horizon in the sense of over the long period of time, that 30-year bull market in bonds that you mentioned is also a 30-year bull market in central bank stimulus working. So things slow down GDP-wise or we have a high unemployment rate, and what do we do? We lower rates. Now you're at zero, and so the ability to continue to stimulate growth through lower rates is very, very challenged at the moment. In fact, arguably it's working in reverse. So over a longer period of time it seems hard to kind of get growth going which would then raise inflation or raise real rates along with it. In the shorter term actually I'm concerned because I think there's a lot of complacency. We're more or less expecting rates to be zero forever. While they may be low for a long time or while the natural rate of rates could be lower, I think that we don't anticipate even any kind of inflation, any kind of wage inflation or service inflation which we're actually getting. The only kind of lower inflation we're getting now or continuing to get is goods inflation. So I actually think there are some things that could pressure us higher in say ten-year rates, but I'm not talking three and a half or four percent. I'm talking about two and a half from where we are now which is kind of 150 something.

CONSUELO MACK: Most of Wall Street and certainly the financial press has been fixated on the Fed, when they're going to raise rates again, and even if the Federal Reserve does raise rates again soon – they did so last December – we know it's going to be gradual. Right? What difference is it going to really make? Is that the wrong place for us to be focused as far as kind of whatever the dangers might be to the bond market at this point?

JASON BRADY: I think it is, and the reason I think it is, is less because if the Fed raises once or twice or three times, it doesn't matter or it does because clearly the pathway matters somewhat. Williams came out and said, "Hey, look, if we raise earlier we can actually be more gradual with this. We don't want to be put into a place where we're kind of behind the curve and catching up." The reason I think the fixation is sort of frustrating, frankly, is that it's really not an economic question anymore. Even in the stock market you look at the movements of stocks more recently, it's very significantly multiple movements. In other words, let's say P/E movements versus E movements. So earnings aren't really moving, but P/Es are moving a lot, and we are focused on how can the Fed give us more stimulus from a money flow standpoint. In bonds you're seeing huge flows from outside the United States because the interest rate differentials up until recently were very favorable to going and buying say the U.S. ten-year versus the ten-year…

CONSUELO MACK: Because our rates are much higher and our currency's been going up.

JASON BRADY: Exactly. That has nothing to do with the effectiveness of the instrument itself. So pushing people to do something that in the short term is interesting or effective or not for them in the short term is not really a great long-term policy. The scariest comment I have heard is that you don't invest in bonds for income; you invest in them for capital appreciation. I think people who do that are missing the point of fixed income and just looking to sell it onto the next buyer which may or may not be a central bank.

CONSUELO MACK: Except I think that you did say to me in an earlier interview that we have to revise our attitude towards the role that bonds play in our portfolio.

JASON BRADY: Oh, sure.

CONSUELO MACK: Because they used to be an income-producing vehicle, and they also used to provide stability. They were a non-correlated asset to stocks. Now what?

JASON BRADY: I think we've taken away the sort of safe asset. So people are buying bonds to almost ... well, they're buying bonds because they've performed well. Hey, look. If you bought any kind of bond, whether it's high-yield because credit's done well or it's a 30-year Treasury because interest rates have come down significantly, you've done very well, and generally you've done better than the stock market so everybody's excited to go into bonds. But the reality is all you're doing is pulling forward return in bonds because if I buy a ten-year Treasury at a 158 yield and I hold it for ten years, probably going to get 158. It's just how this works.

CONSUELO MACK: The government's not going to call the bond or whatever.

JASON BRADY: It's not able to, et cetera, et cetera, and we hope that the U.S. doesn't go bankrupt because we'll talk about other problems then. So we've pushed the return out of that security. In the past that used to have a very important part of asset allocation which was to say, as you pointed out, steady return, ballast for your portfolio. The trouble is when so much of that kind of asset allocation methodology came about, the real yield, so the after-inflation return before tax but after-inflation return of say the ten-year – we'll just kind of use that as the reference instrument – was four percent. If the ten-year Treasury paid you four percent after inflation, so that's what your measure is, but let's call it CPI, let's call it six percent ...

CONSUELO MACK: We'd be thrilled.

JASON BRADY: You'd buy a lot. So now that's not an option. So now what do you do? Right? So people are buying them not for that return. They're buying it for, hey, this price return but not the income. The price return.

CONSUELO MACK: Total return.

JASON BRADY: Since you're just borrowing that from the future, you're basically picking up nickels in front of the steamroller. You're kind of really pushing on the value of that instrument, the value of the instrument both in itself but in your portfolio as well. Maybe the toughest allocation challenge that I see, asset allocation and just broad portfolio challenge for everybody, is in addition to that building block being no longer four percent real but zero percent real, you are stuck in an environment where the other options are added on to that now zero percent. So your total return is lower, and that safety return actually is giving you more volatility. In 2013 we saw rates rise. Stocks around the world generally fall. The U.S. did better. Spreads on say corporate bonds rise, so in other words, prices fall even more than Treasuries did. Suddenly there's positive correlation between your safe asset, Treasuries, and your riskier assets. In other words, they're moving in price together, but our whole asset allocation methodology is that they move in opposite ways. So if now rates are at very, very low levels, i.e., bonds are at very, very high levels, and stocks are at very, very high levels, in other words there's been positive correlation which has been very beneficial to everybody ...

CONSUELO MACK: Yes, no matter what you're investing in.

JASON BRADY: Correct. If the positive correlation continues but it continues in some potential rising rate element, that's less good. Then there's no ballast. There's no safe asset. There's no home base.

CONSUELO MACK: What do you do then? I know you run multiple portfolios. I mentioned them in my introduction to you. I mentioned three funds, but one of the funds that I'm thinking of where you run the fixed income portion is the Thornburg Investment Income Builder Fund, and the last time I looked you were underweighting the bond portion. Correct?

JASON BRADY: Correct.

CONSUELO MACK: So what is your strategy? Are you investing in dividend-paying stocks?

JASON BRADY: Dividend-paying stocks in fixed income. So the idea is to provide income for our clients.

CONSUELO MACK: You're doing that for income. That's where you're getting your income.

JASON BRADY: Correct.

CONSUELO MACK: The most income now.

JASON BRADY: And what dividend-paying stocks do is they incentivize management to become good capital allocators because it's tough to cut a dividend, because it's a shareholder focus, because they don't necessarily have as much money left over to do crazy stuff. In fact, if I give you two companies, they both earn $100 bucks. One pays $50 bucks in dividends, one pays zero, so one invests 50, Company B invests 100, which one grows its earnings faster over time? As defined as earnings per share over the next 10 years? It's the company that actually pays a dividend.

CONSUELO MACK: And why is that?

JASON BRADY: Having talked to a lot of companies I can tell you that it's really about capital, but it's also about business models that compound, and so they'll invest in compounding business models as oppose to go do something crazy over here, some waste of money or whatever. So they tend to be good allocators but they also tend to be good business models that are sustainable and compounding. So that gives you better returns over time than not, generally.

CONSUELO MACK: Investing in dividend-paying stocks. You're not getting it from bonds.

JASON BRADY: Fixed income. Exactly. I'd love to. Actually so it's great when the environment is such that I can get income from fixed income that provides a real sort of a base load income to use sort of utility semantics. Hey, this is going to plug away and give you income, and then I've got something which inevitably is more volatile in stocks than in bonds pretty generally, and yet that's going to grow its dividend over time, and so I have this nice balance in a self-balanced portfolio, all the while providing income which people need. So now why do I not hold bonds or not as many? It's about 12 percent today.

CONSUELO MACK: Which is really low.

JASON BRADY: It's pretty low.

CONSUELO MACK: Historically? Or is it? You tell me.

JASON BRADY: Well, our range has been from 46 to nine, so in general we're right around 25 percent. It sort of tends to swing around based on where value is. If I'm an economic buyer of fixed income, in other words I'm trying to make money for my clients buying in fixed income, I'm competing with infinite balance sheets controlled by central banks. Look. They don't buy maybe a high-yield security I might look at or they don't buy various other things that I might be looking at, but they buy Treasuries which then, as we talked about, kind of cascades through and ends up significantly affecting valuations. If that fixed income portion doesn't act as much as ballast, in other words having that negative correlation ... well, stocks fell a lot but my bonds held up ... if that correlation actually is more in sync, then the value of that even as a portfolio position is challenging. So, look. There are always individual things to do. In February we saw risky fixed income completely fall out of bed, and there were things to look at and pick up and we did, but in general you think about, okay, what's the portfolio position? What are we trying to do? Income, for sure. Fixed income unfortunately doesn't provide that role. In '08 and '09 we were half fixed income, and it was tremendous.

CONSUELO MACK: Yet if you look at dividend-paying stocks for the most part, as an asset class, they're expensive.

JASON BRADY: Yes, in the U.S..

CONSUELO MACK: In the U.S., and I'm wondering about the sustainability of dividends. There was an article in *Wall Street Journal* recently that said that S&P 500 companies are paying 38 percent of their net income out in dividends which is pretty high. It's certainly higher than it's been in the U.S. in recent years.

JASON BRADY: In the U.S.

CONSUELO MACK: Therefore, so in the U.S., dividend-paying stocks in the U.S. as an asset class, too expensive? Maybe the dividend payout ratios aren't sustainable. What's your take on them?

JASON BRADY: Too expensive and they are sustainable.

CONSUELO MACK: They are sustainable.

JASON BRADY: Well, just because dividend payout ratios in the U.S. are much lower than everywhere else in the world. Now you could argue that that reinvestment is part of the reason why U.S. has dynamic growth, but actually the literature says the opposite. The literature says that if you actually pay more of a dividend, then you're making a better capital allocation decision. But relative to the rest of the world, I don't think that you're running into trouble with 38 percent or relative to business models I don't think you're running into trouble with 38 percent but expensive. So you look at what at Thornburg we might determine the "expensive defensive". So staples, consumer staples would be a great example. U.S. telecom. U.S. telecom has had a great run, and there aren't that many but large cap U.S. telecom is pretty expensive. Very similar business models outside the United States.

CONSUELO MACK: Like AT&T.

JASON BRADY: So AT&T is a great example, a great company who's done a good job. Fine, but it's not cheap. Outside the United States is totally a different story.

CONSUELO MACK: The telecoms outside the U.S..

JASON BRADY: Correct.

CONSUELO MACK: So for instance, what would be the equivalent?

JASON BRADY: China Mobile. So China Mobile's growing really quickly. Look. I can give you the pluses and minuses and all this stuff. There are some regulatory challenges that they have. They're very large and so the regulators are kind of trying to make sure that they're not too dominant but growing quickly, very well capitalized and not expensive. So we can say that dividend-paying stocks are expensive, and in the U.S. utilities for sure, large cap telecom, yes. Financials which used to be a big part of the dividend-paying in the U.S., a totally different story now. Now financials aren't in the U.S. what I term particularly expensive but their dividend payment ability is much smaller.

CONSUELO MACK: The big banks certainly are.

JASON BRADY: Banks regulatory pressure. I think that could get better because I think some of the thinking around bank profitability is different, but let me give you an example. So in Europe the regulator has generally been frowning upon telecom companies making money. Rates for consumers are low. Great. The trouble is investment in the infrastructure is low which kind of makes sense. Right?

CONSUELO MACK: Yes. Not good for the long-term communications infrastructure for Europe.

JASON BRADY: Exactly and look. This doesn't go in a straight line. What do they allow and not allow, and how much competition? How does this look? Rates, et cetera, but I think the general learning process has been, well, just low rates is not the only thing we're looking for. We're also looking for investment because we want to keep up, and telecom infrastructure and communication infrastructure is a clear competitive advantage or disadvantage.

CONSUELO MACK: Absolutely.

JASON BRADY: Like in everything. So saying, okay, we won because the rates were low, but you're dialing on a rotary phone, like it's maybe not such a big advantage.

CONSUELO MACK: Is that an opportunity, a potential future opportunity then?

JASON BRADY: So I think so.

CONSUELO MACK: Telecom in Europe for instance.

JASON BRADY: Right, so we own some telecom companies in Europe, and each jurisdiction is a little different and each situation is a little different and each valuation is a little different, but it gives you a flavor for the difference in how telecom can be perceived or how telecom can be valued in various places in the world.

CONSUELO MACK: On the debt side of these investments, I mean you're also running the Limited Term Income and the Strategic Income funds which are bond funds, so you have to invest in the bond market whether you like it or not.

JASON BRADY: It's true.

CONSUELO MACK: So where are you finding opportunities when you have to invest in debt markets?

JASON BRADY: Well, the good news is I'm not slavish to a particular benchmark, especially in the Strategic Income Fund. I have a lot of flexibility. The Limited Term Income fund is a high-quality portfolio, 65 percent at an initial investment at A and above and the whole thing is investment grade. So there I have a little more restrictions, but there are still things to do. It's just don't take risk when you're not getting paid to take risk. It's a pretty simple thing. Even if the ten-year Treasury as an example goes from 150s to 50s basis points, my scope for appreciation is pretty small, and I'm not ...

CONSUELO MACK: Is it?

JASON BRADY: Well, it's nine percent which is more or less what the return has been thus far, but it's nine percent.

CONSUELO MACK: That's pretty good.

JASON BRADY: It's good, but spread that over ten years. Now I can buy it and then sell it some other person who thinks that it's going to go from 50 basis points to negative 50 basis points, but now we're starting to talk about a greater fool theory of investing, and these aren't stocks with a potentially infinite up side. This is a bond that kind of can't go very far and already is negative in yield.

CONSUELO MACK: But how many times have you actually held a ten-year Treasury to maturity?

JASON BRADY: I actually try to hold.

CONSUELO MACK: Oh, you do?

JASON BRADY: I really try to hold things that I'm buying to maturity in general now.

CONSUELO MACK: You do.

JASON BRADY: Yes.

CONSUELO MACK: So therefore, how far out do you go? I mean are you ... ?

JASON BRADY: So the Limited Term Income fund goes out to ten years, and the return on that portfolio is in the mid to high teens in general. So we're actually kind of holding stuff for a pretty long time. I average obviously more than five years. So yeah, when I invest in something, I don't want to have to sell it to somebody else who I think is dumber than me to make money.

CONSUELO MACK: But you wouldn't be averse to that. Right? Because ...

JASON BRADY: I wouldn't.

CONSUELO MACK: Because that's the way it kind of works. It's a zero sum game.

JASON BRADY: It doesn't work that way in bonds.

CONSUELO MACK: Oh, it doesn't. Interesting.

JASON BRADY: Well, because at the end it matures, and I get my money back.

CONSUELO MACK: Yes, you get your money back.

JASON BRADY: I don't have to sell it. Now if I don't like owning it to maturity, I got to find somebody else who does. On purchase I don't like it, but I'm just hoping that somebody else buys it. I think that's trouble.

CONSUELO MACK: So it's harder in bond land.

JASON BRADY: Now that said, there are things to do. I mean there are things even in the high-quality space to do. I think the money market reform that's happening right now is really shaking up the market certainly in the front end, and if you can navigate that, I think there's some pretty nice things that you can do to sort of keep cash…

CONSUELO MACK: For those of us not familiar with the reforms that are occurring in the money market, what should we be looking for? Because most of us have been avoiding money markets because we can't get any yield in money markets.

JASON BRADY: So now you can.

CONSUELO MACK: Now as of October 14th, is there a big change that's going to occur?

JASON BRADY: So the change that's happening is that despite the fact that the biggest money market failure of the last cycle was actually a government bond portfolio what the regulation is, is that government bond portfolios are allowed to keep that stable one dollar NAV which has always been a fiction, but because volatility has been so low, okay, it kind of works out.

CONSUELO MACK: So it never broke the buck was the whole promise of money market funds.

JASON BRADY: Correct, and so the regulators are kind of looking at this, saying, "This is kind of a bad fiction unless you're buying stuff that's very, very safe." Now if you buy mostly stuff that's very safe but a few things that are not safe which is what happened in the last cycle, then you break the buck anyway, but in any event if you're a money market fund and you want to buy government bonds, have at it. You're allowed to have a one dollar stable NAV. If you're going to buy anything else or significant amounts of anything else, then you have to float your NAV. Now lots of people don't like that because ...

CONSUELO MACK: Your net asset value.

JASON BRADY: Yes. So people don't like that. People want to have a ...

CONSUELO MACK: Stable.

JASON BRADY: ... stable NAV and some other regulations and legal strictures people have to have a stable NAV. So a lot of money in money market land is moving towards government bonds. So the short end of the Treasury market is very, very low in yield. At the same time, the London Interbank Offered Rate, the LIBOR rate, a floating three-month rate that has been controversial recently but generally is a benchmark around interbank lending, has risen a lot.
CONSUELO MACK: It's still under one percent, but it's a lot higher than ...

JASON BRADY: If I'm going to buy a very high-quality corporate bond that's floating – it's maybe one year long – a U.S. utility which despite my distaste for the stock valuations is a pretty stable business model for one year. I can get that at greater than one percent. I'm approximating the five-year Treasury yield for a one-year that doesn't have any duration risk that floats. Why? Because the regulations have pushed people out of those assets. So the minor amount of incremental risk that I'm taking to go from short-term Treasuries to short-term corporates and actually the risk I'm actually giving up, in going from fixed rate to floating as far as making sure I'm not really exposed to big moves in rates ... these are all short. It doesn't really matter, but I'm actually getting paid a lot for that. Now a one percent return or a little over one percent return is not going to make your retirement. You're not going to suddenly be able to retire to Hawaii when before you were going to Ronkonkoma, but still that's ...

CONSUELO MACK: It's better and it's cumulative.

JASON BRADY: As I said, don't take risks you're not getting paid to take. If I'm taking a small amount of incremental risk and I'm getting paid a fair amount for it, okay. These are the small winds that I have, but that's important.

CONSUELO MACK: As we wrap up this interview, we always ask our guests for the one investment that we should all own in a long-term diversified portfolio. What would it be?

JASON BRADY: Sure, I think U.S. investors tend to be very focused on what they can see and touch right around them, so they tend to be focused just like everyone in every market tends to be very kind of home-biased, and more recently that has been a very high-performing market, so the S&P 500 has been one of the best performing asset classes you can buy over the last several years. So it's important I think to keep in mind that there are other things to do, other places to invest. I'm thinking about international investment, and specifically thinking about dividend investment outside the U.S. I think the compounding returns piece is important. The quality of the business model is important, and I think that the valuations there are pretty interesting. So I think that really serves people over a very long period of time which is the kind of time horizon lots of folks are going to need to have. I mean even if you're retiring in three or four or five years, one hopes that you're going to live for a whole lot longer than that. A lot of people have said it's not really a finish line. So you got to think about participating in global growth over a really long period of time but perhaps getting some income along the way and some compounding from both the business model and the return.

CONSUELO MACK: So dividend-paying, foreign-based companies?

JASON BRADY: Correct, correct. Exactly. The dividend-paying stocks outside the United States.

CONSUELO MACK: Terrific. Jason Brady, thank you so much for being with us for the first time on WEALTHTRACK.

JASON BRADY: It's a pleasure.

CONSUELO MACK: Appreciate it.

CONSUELO MACK At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term.
This week's action point is: Don't give up on bonds. U.S. and global growth is slow. The recovery from the financial crisis is long in the tooth and there are enough potential geopolitical problems to keep a lid on irrational economic exuberance. Good quality bonds, chosen by proven professionals still have a place in portfolios.

Next week, back by popular demand we will sit down with Robert Kessler to discuss his specialty, the most vilified securities in the bond world, U.S. Treasuries. Why is he even more adamant about owning Treasuries and cash at this point? We will find out!

To hear more of our interview with Jason Brady and why being an English Literature major in college has helped his investment career, go to the EXTRA feature on our website, WEALTHTRACK.com. Also feel free to reach out to us on Facebook and Twitter.
Thanks for watching. Have a great weekend and make the week ahead a profitable and a productive one.