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Bonds Can Be Risky Too

The bear market in common stocks and the very low interest rates currently offered on deposit accounts may be attracting many relatively unsophisticated investors to the bond market. They could be in for some unpleasant surprises.

"Confidence has now faded in the Dow. But faith in the Dow is not gone. There is a difference," was a recent comment from Gary North. He elaborated:

> Confidence encourages buying. Faith retards selling. Confidence is based on this belief: "I can get rich with my money invested here." Faith is based on this belief: "I won't get poor with my money invested here." Faith is therefore retained for a longer period after investors' confidence has begun to fade.
>
> Investors still believe analysts who say, "The economy is strong, so the stock market will eventually rebound. This may be the bottom." People still have some flicker of faith in the Dow. This is why the panic sell-off hasn't hit yet. For as long as people have faith, they will not sell en masse. But they will not buy heavily, for confidence has faded.
>
> We have seen what happens when faith dies: the NASDAQ at 1200 to 1300, down from 5048… people could still get out in July of 2000. Faith had not died… [Now] millions of investors are sticking with the Dow, on the assumption that it cannot retrace its steps to 1982's level of 700, or anywhere near that level. Faith still exists. But confidence doesn't.*

Whether Dr. North's suggestion that the Dow could be headed for much lower levels than most analysts currently deem possible is correct remains to be seen. But the distinction he makes between faith and confidence may be helpful in understanding the current situation: what is it that propelled the NASDAQ index to more than 5,000 in March 2000?

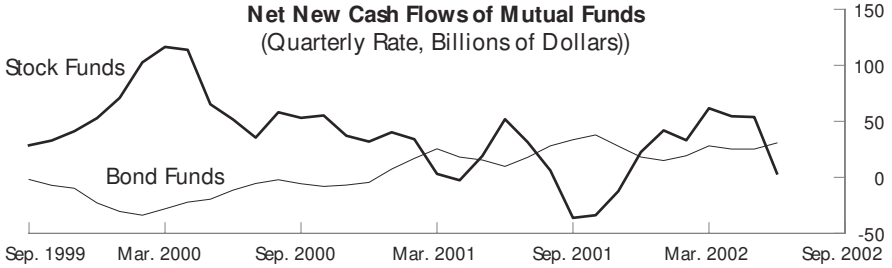
In hindsight it was a seemingly unbounded confidence in the "high technology" stocks that dominated that index. What bought it back down, by more than 80 percent, was not only a collapse in that confidence, but also a shattering of the "faith" in the efficacy of a strategy of "buy and hold." A 4- or 5-fold increase in the NASDAQ will be needed before the old highs can be exceeded, and this may well take much longer than the time horizon of most investors. Many of the hot stocks of the years 1995-2000 are now in bankruptcy, which typically precludes the possibility of *any* comeback for the old stockholders. Probably few NASDAQ investors from two years ago still cling to the belief that their stocks will "come back."

Despite the pronouncements of television's "talking heads" and other "expert" commentators regarding movements into or out of stocks, at the end of each trading day, *every order to sell is matched with an order to buy.* Investors collectively do not move "in" or "out" of specific securities or types of securities. The only exceptions to this are the sale of new issues and the retirement of existing issues, which constitute only a very tiny fraction of the total volume of equity trading. In the final analysis, it is price movements that change the overall composition of investors' holdings—and prices reflect the subjective valuations of individual investors and money managers.

That said, it *is* possible to identify the actions of specific groups of investors. The data for some of these can only be estimated and the estimates are often not very current and subject to revision long after the fact. In the instance of the Federal Reserve's *Flow of Funds* data, the reported net purchases or sales of common stocks and other financial instruments are derived as a residual of all the other estimates, and so incorporate any and all errors in the estimates for other sectors.

However, the monthly reports compiled and published by the Investment Company Institute (ICI, http://www.ici.org) provide timely and relatively accurate data on the monthly net new cash inflows (or outflows) of open-ended mutual funds, which are mutual funds that issue and redeem shares at their shareholders' request. The accompanying chart shows the three-month moving totals of the monthly flows reported by ICI for approximately 1,300 bond funds and over 5,000 stock funds (including a small number of "hybrid" funds that hold some proportion of fixed-dollar claims). These totals reflect the purchase and sale decisions of individuals, money managers, and others who buy, own, and sell such mutual funds.

As the chart clearly shows, during the three years ended in June, there has been a pronounced movement away from stock funds and toward bond funds on the part of mutual fund investors. It may be noted that mutual funds have continued to receive overall net inflows, presumably reflecting ongoing contributions to IRA, 401(k) and similar systematic savings plans. Bond funds incurred net redemptions during 1999 and 2000, and then began to receive a growing stream of net inflows. On the other hand, the massive inflows of stock funds in 2000 have diminished: they incurred net redemptions during last summer and fall and again during recent months.



Source: Investment Company Institute.

* Gary North's REALITY CHECK, Aug. 5, 2002. http://www.dailyreckoning.com/sub/GetReality.cfm

Presumably these trends have been paralleled in the purchases and sales of stocks and bonds by individual investors, at least the less sophisticated ones, who are similar to mutual fund buyers, who have been attracted to bonds by their supposed safety. It is not clear that newcomers to the bond market understand what they are getting into.

Some Bond Basics and Bond Jargon

Bonds are debt securities or, more simply, IOUs. The initial purchaser of a bond has lent money to the *issuer*, which may be a government, an agency of a government, or a public or private corporation. A bond is an issuer's promise to pay a specified rate of interest periodically, most commonly every six months. Sometimes the rate of interest is called the *coupon* rate, and the periodic payments are called the *coupon*. The issuer also promises to repay the principal, or face value, of a bond at a specific future date, which is when a bond is said to *mature*.

At the most fundamental level, a bond is a contract. The contract or *indenture* may include liens on the property of the issuer (or a prohibition against issuing new liens on property that is unencumbered when the bonds are issued), and/or a variety of other obligations to be undertaken by the issuer.

By convention, most bonds are denominated in units of $1,000. Bond buyers, however, are usually required to purchase a minimum of five or 10 bonds, and, when trading bonds after they have been issued it is not uncommon for as many as 1,000 bonds (with a face value of $1 million) to be regarded as a "round lot."

In short, there are substantial differences between bond investments and the more familiar dollar-denominated holdings in accounts with banks, money market funds, savings and loans associations, and similar institutions. The most fundamental of these is that the issuer of a bond is under no obligation to the holder beyond paying interest and principal when due and fulfilling any obligations under the bond indenture. Specifically, the issuer is seldom obligated to redeem the bond prior to maturity.

What this means is that a bondholder who wants his money prior to maturity will have to sell the bond for whatever it will fetch, which may be less or more than its face value. In addition, there is no insurance on bond investments with the exception of certain municipal bonds. As a result of these considerations as well as the various risk factors discussed below, bonds usually offer a higher rate of interest than dollar-denominated accounts, which is no doubt one of the reasons why bond-fund holdings have increased in today's low interest environment.

What are the Risk Factors?

The risks of bond investments are threefold. With the exception of bills, notes, and bonds issued by the U.S. Treasury (which can simply print the money to meet its obligations), there is a *credit* or *default* risk reflecting the possibility the issuer of an IOU will be unable to pay the principal and interest due the bondholder. *Market risk* reflects the possibility that a bondholder may not be able recoup his full investment if he sells the bond. Finally, there is *currency risk*, which is the possibility that the purchasing power of the currency may decrease more rapidly than expected.

Credit Risk

Rating agencies assign ratings to many bonds when they are issued and monitor developments during the bond's lifetime. In the United States, rating agencies include Moody's Investors Service, Standard & Poor's Corporation, and Fitch. Each of the agencies assigns its ratings based on in-depth analysis of the issuer's financial condition and management, economic and debt characteristics, and the specific revenue sources securing the bond. The highest ratings are AAA (S&P and Fitch) and Aaa (Moody's). Bonds rated in the BBB category or higher are considered investment-grade; securities with ratings in the BB category and below are considered "high yield" or "junk" bonds. Rating agencies are far from infallible, but in general the higher interest rates that generally accompany lower ratings are a warning of higher risk.

Market Risk

From the time a bond is originally issued until the day it matures, its price in the marketplace will fluctuate according to changes in market conditions or credit quality. The constant fluctuation in price is true of individual bonds—and true of the entire bond market—with every change in the level of interest rates typically having an immediate, and predictable, effect on the prices of bonds. When prevailing *interest rates rise, prices of outstanding bonds fall.* This brings the yield of older bonds into line with higher-interest new issues. When prevailing *interest rates fall, prices of outstanding bonds rise*, until the yield of older bonds is low enough to match the lower interest rate on new issues.

The more distant the maturity, the greater the risk of significant price fluctuations. As a result, the interest yield on the more distant maturities of bonds of similar credit standing is usually larger than those on the nearer term maturities. However, empirical studies of historical experience have concluded that the differences in yields on bonds of maturities beyond approximately five years have seldom been sufficient to compensate for the increased price volatility of the longer issues.

Short-term interest rates reflect credit demand and supply, with the latter largely determined by the open-market operations of the Federal Reserve. However, the Fed has little direct influence on long-term interest rates, which are said to include an "inflation premium" that fluctuates with inflationary expectations. This premium is the amount that lenders require to compensate them for the decrease in the purchasing power of the currency expected over the life of the loan.

Outlook

It should be noted that the fact that bond prices fluctuate involves the possibility of gains as well as losses. If interest rates decrease, bond prices will increase. If credit standards ease, low-grade bond prices will increase, even if the rates on high-grade issues remain unchanged. If price inflation is less than was expected when a long-term bond was first issued, the real returns to bondholders would surge.

The bond market dwarfs the stock market in terms of the dollar values traded daily (if not in the total of outstanding securities). Large and sophisticated investors dominate such trading. As a result, analysts often scrutinize the relations of long- and short-term interest rates or the interest-rate spread between high- and low-grade bonds for clues to future financial and economic trends. These are presumed to reflect the collective opinions of the most prescient "players" in the financial markets.

However, there is no guarantee that the expectations of the "big boys" will prove correct. For example, during the early 1980s the Treasury issued 30-year bonds with "double digit" coupons—as high as 15 percent. It was widely assumed at the time that the high rates of price inflation experienced in the 1970s were going to continue. Similarly, many investors received high returns on "junk bonds" during the boom times of the 1980s and 1990s.

At present, the Federal Reserve is creating dollars at unprecedentedly high rates and interest rates are at 4- or even 5-decade lows. If only because current rates are so low, without much more room to decrease further, the next major move in interest rates will almost certainly be an increase, especially if the recent pace of monetary expansion becomes apparent in price inflation. Such developments could come as a nasty surprise to the recent entrants to the bond market. ❑

ANOTHER LOOK AT LONG-TERM CARE INSURANCE*

A new book provides valuable information and advice to individuals who are contemplating buying one of the most complicated and expensive insurance products on the market.

One of the gnawing fears of older Americans is that they might end up in a nursing home. As if that prospect is not scary enough, they might go broke paying for it. These fears are fueled by frightening statistics that seem to suggest that the chances of needing expensive long-term care are high. "Nearly 40 percent of people age 65 now are likely to spend some time in a nursing home;" "the average cost of a year's stay in a nursing home is $55,000 and the actual cost can be much higher;" "the average length of stay in a nursing home is nearly 3 years;" and "half of all women and a third of all men who are now over 65 will spend their last years in a nursing home." These are just a few of the statements we have seen in media reports and insurance literature.

Impoverishment is a threat because Medicare, the Federal program that provides health insurance to the elderly, provides only limited coverage for nursing-home care. Medicaid, a joint Federal-state program, covers such care but is available only to those with low incomes and limited assets. Wealthy and middle-class individuals have to "spend down" their income and assets to become eligible for Medicaid. This requirement has given rise to an industry of lawyers and financial planners who specialize in "Medicaid trusts" and other ways for clients to shelter wealth in order to meet the technical requirements of eligibility in the event they need long-term care.

Another option is long-term care insurance. This type of insurance is supposed to help older Americans get the care they presumably will need without becoming impoverished by its high cost. By paying for nursing-home care, it potentially enables the elderly to avoid spending down their wealth on such care or engaging in complicated transfers of wealth in order to get Medicaid to pay for it.

When we first reviewed these policies a decade ago we found that, in general, the limited benefits they promised did not justify their high premium costs. In recent years, however, some of the most objectionable policy features (such as those requiring hospitalization prior to admission to a nursing home) have been eliminated, and many policies now cover not only care in a nursing home but also home health care, adult day care, care in assisted-living facilities, and more. The wider range of benefits now available has made long-term care insurance less restrictive than it once was, but it is still expensive. High premiums, along with confusion over complicated policies and uncertainty about the genuine risk involved, may account for the relatively low sales of these policies. Despite the hype over the potential risks, only about seven percent of individuals age 65 and older have purchased long-term care insurance.

Readers who are thinking about buying a policy will benefit from *J.K. Lasser's Choosing the Right Long-Term Care Insurance* by Benjamin Lipson. The author has written extensively on senior health care and patients' rights. The book is a very readable and informative guide to how these policies work, what services are covered, how benefits are paid, and what to expect when you apply for a policy.

The author notes that the odds of needing long-term care in a nursing home have been greatly exaggerated. Most nursing home stays last three months or less. The frightening statistics showing much longer "average" stays are skewed by a relatively small number of patients who stay for many years. Insurance companies overstate the risks of confinement and impoverishment in hopes of scaring the elderly into signing up for long-term care insurance. As Lipson points out, often these tactics simply scare people away, period. There is little appeal in arranging to spend one's final days in institutions that most people think of as warehouses for the demented and frail.

Indeed, what most people want is a way to *stay out* of nursing homes. As noted, the insurance industry is waking up to this, too. Most long-term care policies now pay for home health care, either as a basic benefit or an additional rider available for a higher premium. At the same time, alternatives to nursing homes are becoming increasingly available. Assisted-living facilities, for example, have proliferated in recent years.

The pace of change in medicine, support services, and demographics almost guarantees that the market for long-term care will continue to change, and it remains to be seen if all the options will succeed. For example, there already are indications that the assisted-living approach—an untested and largely unregulated industry—is running into problems. According to recent news reports, developers have overestimated demand for these centers and overbuilt. Occupancy rates have leveled off, and operators are under pressure to cut costs and to lure new occupants. How many of these facilities will remain financially viable is anybody's guess.

As long-term care insurers move beyond nursing home coverage to a broader range of benefits, they enter areas in which they have little underwriting experience. To limit their future liability, they carefully screen applicants and pay limited benefits under carefully defined circumstances. Mr. Lipson's book describes how they do this.

High Risks Need Not Apply

To screen out high risks, insurers reject virtually any applicant who they think is likely to make a claim. In this regard, these policies have changed little since we first reviewed them a decade ago. The book includes a long list of medical and physical conditions that typically render applicants uninsurable, and an even longer list of those that warrant a higher premium. Unlike life insurers, who are concerned with your risk of dying, long-term care insurers focus on your risk of needing care. Thus, they might consider a person with a history of cancer to be a better risk than someone who uses a four-pronged cane.

A key part of the screening process is the applicant interview, when an examiner comes to the your home to evaluate your physical and mental condition. Examiners evaluate your mobility and survey your ability to do basic "activities of daily living" (ADLs) such as bathing, toileting, dressing, and getting in and out of a chair. They also conduct various cognitive tests, such as word memory games and asking you to count backward by threes.

More subtly, the interviewers observe your demeanor, grooming, and living environment, looking for any indication of memory loss, confusion, or lack of mobility. They may ask to see your driver's license, not for identification purposes but because maintaining a license is a sign of mobility. They may ask you to tell your own version of your medical history even though you and your doctor have already documented it, partly because your ability to explain and remember serves as another test of your cognitive skills. They may ask you to show what prescriptions you are taking, partly to see if you have trouble remembering them.

You cannot avoid these tests (refusing to cooperate would be an automatic

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* This article is a review of *J.K. Lasser's Choosing the Right Long-Term Care Insurance* by Benjamin Lipson, a John Wiley and Sons book, 2002, 270 pp. including index, $16.95 softcover.

disqualifier), but Mr. Lipson suggests ways to improve your performance. For example, schedule the interview at your best time of day, gather all your prescription bottles beforehand, and clean the house. Avoid making jokes to your doctors about "senior moments" because that might show up in the medical notes they must provide to the insurance company. Simply knowing what to expect is a key advantage provided by the book.

Policies Remain Confusing

Insurers also try to control their risks by carefully defining the conditions under which they will pay benefits. These "benefit triggers" are based on your ability to perform the same activities of daily living mentioned above. The degree of impairment that triggers benefits varies. Some policies require that a claimant be unable to perform, say, two of six ADLs for 90 days in order to qualify for benefits. Others may set the bar at three out of six, or allow benefits to be paid if a client is able to carry out activities but is cognitively impaired.

The standards for judging impairment also vary among companies. Some pay benefits if you need "substantial assistance," e.g., someone has to dress you. Others require that you need "hands-on" assistance (someone to button your shirt) or "standby assistance" (someone within arm's reach while you dress yourself). It is crucial to read the fine print, but the confusing variety of definitions and standards makes it difficult to know whether a policy is providing adequate protection.

Other policy features to consider include the length of time you want to receive benefits, the amount of the daily benefit, an option to waive premium payments after you begin receiving benefits, and a return-of-premium benefit that allows you to get a partial refund if you cancel the policy. You can also buy a benefit that is indexed to price inflation. This is essential, but here, too, insurers have come up with a confusing variety of indexing options, and all of them substantially increase the price of the policy.

Another key choice is whether to choose an indemnity policy (which pays a fixed daily benefit and lets you decide how to spend it) or a reimbursement policy (which pays for the actual services you receive, up to a preset limit). Although indemnity policies have long had a bad name, for long-term care they may be the better choice because they allow greater flexibility. For example, you can pay a relative or neighbor to provide care rather than having to go through a licensed home health care agency that is approved by the insurance company.

As this discussion suggests, choosing the features you want and deciphering the fine print of a long-term care policy is complicated. Assuming you can figure out which features you want and how the policy works, you also have to be able to pay for it. Comprehensive long-term care policies remain among the most expensive insurance products on the market. Lipson's book does not rate policies or quote premiums. However, according to Quotesmith.com, a 65-year old can expect to pay in the range of $2,500-$6,700 per year for a policy that pays a $200 daily benefit for three years with inflation protection. Premiums rise steeply with age. A 75-year old might pay $6,300-$17,000, assuming he qualified for insurance. (The odds of being rejected or charged a higher premium due to health problems also climb steeply with age.) Many prospective buyers will not be able to afford an adequate policy. They will be tempted to buy a cheaper policy whose benefits are too small or limited to do much good.

Even if a policy is affordable when you first buy it, it may not be later on. Most companies promise that "once you are accepted for coverage, your premium will never increase because of your age or any changes in your health." As Lipson notes, these words are misleading. The companies are promising only that they will not single you out for a rate increase. They are free to raise premiums for your entire class of buyers. It would be prudent to count on higher premiums.

Even a top policy, it should be noted, may not keep you out of a nursing home. An underlying assumption in much of this book is that the home health care benefits that are now such a popular feature of long-term care insurance will do just that. Unfortunately, the health conditions that trigger benefits for this care usually are *not* the mild impairments that lead many elderly to get help with cooking, house cleaning, and shopping in order to help them maintain independent life-styles. Rather, home-care benefits usually become available only under the same restrictive conditions that are used to qualify for nursing-home benefits. That is, the insured must be unable to perform one or more basic life activities without assistance.

The problem is that individuals who require this much care probably need round-the-clock assistance or supervision. But full-time paid care costs even more at home than it does at a nursing home, and most policies pay benefits sufficient to cover only a few hours of care per day. (Some policies require that care be provided only by licensed caregivers, who usually charge more, which further limits the amount of care that can be purchased.) This may be adequate if the insured can rely on a strong network of family and friends to provide care the rest of the time, every day. Otherwise, there would be too many gaps to fill. Many, if not most, of the elderly who need this degree of care cannot get it through informal arrangements.

In short, the home-care benefits currently provided by long-term care policies do not become available until the insured needs substantial care. If you do qualify, the benefits probably will not buy enough care to keep you out of a nursing home. You will still have to lean heavily on family, friends, and care paid for out-of-pocket.

Other subjects covered in Lipson's book include alternatives to long-term care insurance; tax considerations; and how to choose a financially sound insurance company.

There is also a very useful discussion of how to deal with pushy agents and a list of questions that insurance companies hope you never ask. The author, who is also an independent insurance broker, has some nice things to say about agents but devotes many pages to exposing their shady sales tactics.

Anyone shopping for long-term care policies, which are among the most complex insurance products sold, would be foolish to expect to get unbiased, accurate, and comprehensive information from an agent. Mr. Lipson's book provides the information you need to decide whether you need to buy a policy and, if so, what type of policy and coverage you want. After reading his book many seniors may decide not to buy a policy. But at least they will be making an informed decision, and they will have a better idea of what factors to consider if they want to make alternative arrangements for care. ❑

PRICE OF GOLD

	2000	*2001*	—— *2002* ——	
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