

# The Fortnighter

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In case you missed it, one of the biggest financial news items of the past few weeks was the increase in long-term bond yields in two key markets – Japan and the U.S.

If you read the last Fortnighter you know the reason for the Japanese “jump”, but the sudden spike in US 10-year Treasury yields was the real attention getter. Whether this is the start of the long-awaited reversal in interest rates is anyone’s guess (there have been a number of false starts over the past few years) but the move was substantial.

The current ultra-low interest-rate environment has had a number of interesting consequences - and I’d like to talk about two of them here. The first is that bond BUYERS in the developed world are still accepting very low long-term rates, when more and more risks are appearing on the horizon. Some sovereign (i.e. country) 10-year bonds are yielding less than 1% - if inflation in those countries rises to 2%, does it really make investment sense to lose 1% per year in real terms for 10 years??

On the other side of the coin, ultra-low yields are leading to some interesting behavior on the part of bond ISSUERS.

A case in point is Apple. All the investment world knows that Apple is sitting on a veritable mountain of cash (some \$140 billion!!) and the company continues to generate annual free cash-flow in the \$40 billion range. Yet Apple just issued their

first bonds. The reason? The rate Apple pays on their bonds is far less than the company’s “cost of capital” – money they earn by investing it in the business.

A similar announcement was recently made by another technology company, EMC Corp. EMC is “only” sitting on about \$8 billion in cash. Like Apple, EMC wanted to retain the cash in their business, but they also wanted to initiate a dividend on their common shares. So, they floated a bond issue and announced their first dividend.

Investors appear to love dividends almost as much as they love receiving bond interest. After the dividend bumps, UP went both Apple and EMC’s stock price.

Now, I know that the best time to borrow money is when you don’t really need it, but this seems like “robbing Peter to pay Paul”. Why would I be more positive on a company if the dividend I receive from them is simply money they’ve borrowed from somewhere else?? If there’s really more value in re-investing profits back into a business, why issue a dividend at all?

Because it’s marketing. Investors want dividends, so companies pay dividends – even when, perhaps, they shouldn’t. One company that understands this is, ironically, run by an investor. It’s never paid a dividend and it’s done quite well over time. It’s called Berkshire Hathaway and the investor in question is Warren Buffett.

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