ROUND TABLE
WEALTH MANAGEMENT

RISING RATES:

A BLESSING IN DISGUISE FOR BOND HOLDERS

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With the recent increases in interest rates, many investors begin to question their allocations to fixed income. These questions and doubts are not without reason: bond values move in the opposite direction as interest rates, so if rates continue to increase, it is only natural to assume that bond prices will continue to deteriorate. However, there are compelling reasons to invest in bonds even in today's rising rate environment. History shows that fixed income has rewarded patient investors who weathered bouts of rising rates and declining bond values, providing them with higher portfolio yields, and higher total returns over the long-term.

Fixed Income is (mostly) Math

Underneath the seemingly complex fixed income market is a mathematical foundation. Unlike equity prices that trade on what can be unpredictable corporate earnings and valuations, fixed income prices at their core are based on current interest rates, the coupon payment, and the repayment of the bond at maturity.[1] Another important distinction between equity (stocks) and bond prices is that while stocks theoretically have an infinite life, bonds will eventually mature and be repaid at a specified date. Therefore, if rates are increasing, this allows investors to take proceeds from a bond that has matured (or sell one that hasn't) and invest the proceeds in a bond with a higher coupon rate, and thus receive increased income. This simple yet often ignored component of fixed income investing can help mitigate the negative impact that higher rates have on bond prices while increasing the yield (and total return) of a fixed income portfolio.

Patience is Rewarded

With rates at such low levels for so long, it is easy to forget that we've been here before. The most analogous period to the current environment may be that of 2004-2006, when the Federal Reserve steadily increased the Fed Funds Rate[2] from 1.00% to 5.25%.

	Change in Fed Funds Rate	Cumulative Total Return of Bond Market
2004 – 2006	+4.25%	+6.54%
2015 – Present	+1.50%	+4.39%

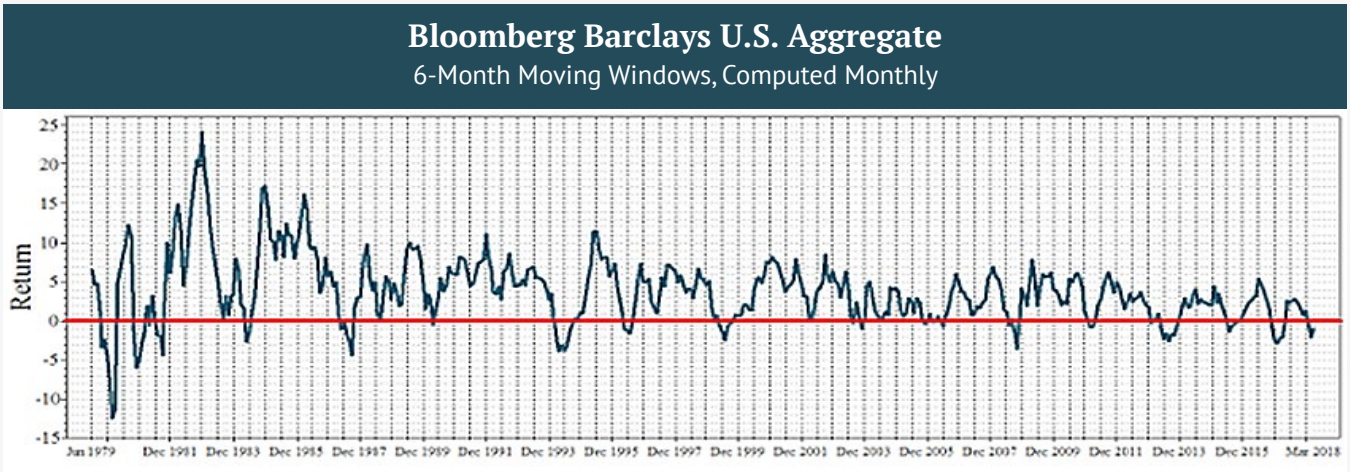
Source: Bloomberg. StyleAdvisor.

[1] We will disregard credit spreads or defaults for now given our focus on interest rates.
[2] The Fed Funds Rate is the benchmark overnight interest rate that financial institutions charge to lend to other financial institutions. It is set by the Federal Open Market Committee (FOMC) of the Federal Reserve.

Despite the increase in the Fed Funds Rate, an investor holding a broad fixed income portfolio during the 2004 to 2006 rate rising cycle would still have experienced a positive cumulative return of 6.54%[3] due to the increased income generated throughout the period. Similarly, an investor in a broad fixed income portfolio today would have experienced a cumulative return of 4.39%[4] since the Federal Reserve started increasing the Fed Funds rate in December 2015.

Expanding our analysis to all past time periods further shows that an investor stands to profit from fixed income during a variety of market environments, rate-rising cycles included. However, the one caveat is that they must be patient and invest in fixed income for the long-term. Approaching fixed income with a short-term trading mentality increases the probability of capital loss. The effect of time horizon on fixed income return is illustrated in the following charts.

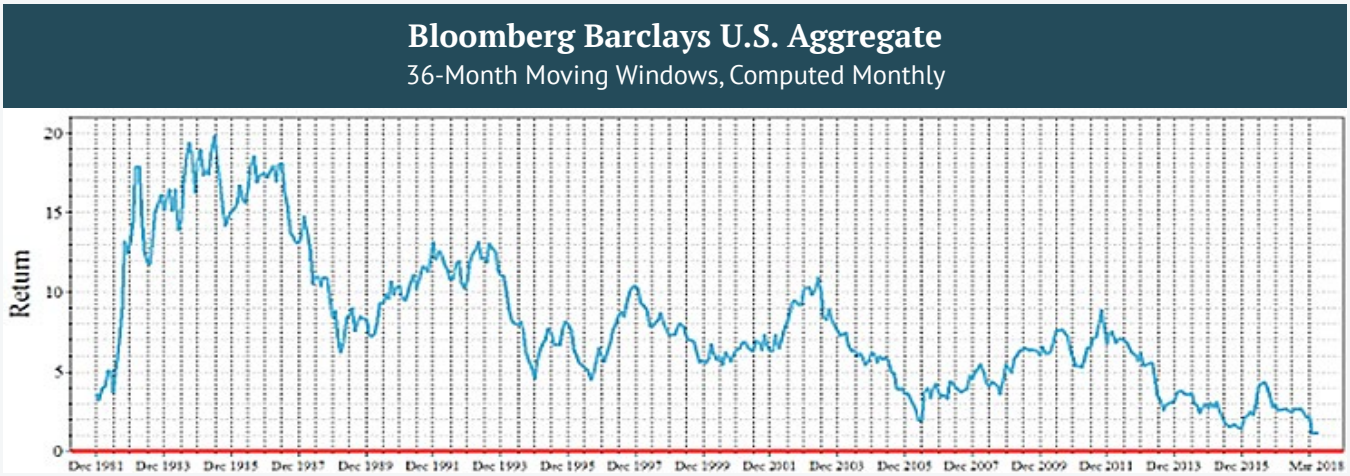
In the chart below, we depict a rolling 6-month return of the Bloomberg Barclays U.S. Aggregate Index. This can be equated to what returns would be for holding a bond portfolio for just six months at any given point in time (i.e. as of 03/31/2018, the index returned -1.08% over the prior 6 months). The chart shows that having short-term holding periods can lead to erratic and often negative returns.



Source: Zephyr StyleAdvisor, As of 3/31/2018.

However, when we look at what returns would have been for a long-term investor with a holding period of three years, the data tells a different story. While returns have fluctuated from as high as 20% to 1% due to the absolute level of interest rates, the returns have never dipped below zero. In other words, if an investor bought and held a bond portfolio[5] for at least three years, they never would have experienced a negative return on their original investment no matter when they invested over the last 40 years! This applies whether it had been during a falling interest rate environment or rising interest rate environment.

[3] Measured by the Barclays U.S. Aggregate annualized return from 05/31/2004 to 06/30/2006.
[4] Measured by the Barclays U.S. Aggregate annualized return from 11/30/2015 to 03/31/2018.
[5] While an index by definition is not investable, we will use the Bloomberg Barclays U.S. Aggregate Bond Index as a proxy for a diversified bond portfolio.



Source: Zephyr StyleAdvisor, As of 3/31/2018.

Stay the Course…

While we agree with the argument that rates are more likely to rise going forward, an investor can still benefit from positive returns in the asset class, as evidenced above. We recognize that recent returns have been negative, but we must keep in mind the portfolio's long-term goals, and remember that the backbone of an investor's portfolio allocation is diversification. Therefore, we do not recommend exiting fixed income completely in order to avoid making one sided bets that can be detrimental to a portfolio.

…But Be on the Defense

However, certain adjustments can be made within a fixed income allocation to limit the short-term impact of rising rates. Insulating against rising rates can be as simple as paring back fixed income exposure within your portfolio. However, reducing fixed income for some investors may not be an option, as this would translate into taking too much equity risk. A more tactical approach within fixed income may be needed. A defensive approach could be accomplished by either lowering the duration of the fixed income exposure or by favoring credit risk over interest rate risk. Duration is a measurement of the sensitivity to changes in interest rates and shorter maturity bonds have less duration. These shorter maturity bonds are currently an attractive alternative as the yield curve is relatively flat. This means investors are not giving up much yield while considerably reducing interest rate risk. Taking on more credit risk also may be an attractive area to obtain added yield, as corporate fundamentals remain strong and the risk of wide spread defaults remain low.[6]

[6] Credit risk occurs when investing in bonds that have the potential to default on their debt. In order to compensate investors for this risk, these bonds generally have higher yields.

Conclusion

As we progress through a period that has so far seen a sharp rise in interest rates, do not panic if fixed income generates a short-term negative return. Higher rates are ultimately a good thing for investors, and patient investors that ride out the short-term volatility will be rewarded with higher yields and higher total returns over the long-term. If you are interested in learning more about how your portfolio may be impacted by higher rates and if any adjustments should be made, please contact a Round Table Advisor.