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From the desk of Research

Stop worrying about rising interest rates

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There is much fear and angst circling U.S. government bonds these days. The view is practically universal – interest rates will rise as the Fed phases out quantitative easing in 2014 and begins raising short-term rates in 2015 and beyond. Unfortunately, the financial news media has blown this story way out of proportion with inflammatory headlines designed to capture attention. Narratives I've seen include "the coming bloodbath for bond holders" and "the imminent bursting of the 30-year bond bubble."

We take a long-term view when designing portfolios for our clients using reasonable estimates of future long-term expected returns, volatility and the correlations produced by the various asset classes. U.S. government bonds, such as treasuries and TIPS, are a unique asset class that deserves a significant role in an investment portfolio.

U.S. government bonds provide an appropriate counterbalance to stocks and a variety of alternatives such as real estate, high-yield bonds, reinsurance, commodities and hedge funds. U.S. government bonds provide a long-term return above inflation, have a low correlation with other asset classes and will likely rise in value during environments that are harmful to equities and high-yield bonds, such as an equity bear market, a market crisis and recessions. In taxable portfolios, municipal bonds serve a similar role, while slightly introducing liquidity and credit risk, but with an attractive effective pre-tax yield.

We specifically design our bond portfolio to have an effective duration of approximately four to five years, which we'll discuss in more detail later. Duration, in bonds-speak, provides an estimate of how sensitive the portfolio is to interest rates. The rule of thumb is that if interest rates rise across all maturities by 1%, a portfolio with a duration of five years will lose 5% in value before accounting of interest payments.

With that background, here are three reasons we're not worried about rising interest rates.

The experts and consensus are often wrong

The experts and consensus often incorrectly predict what stocks and bonds will do in the future, especially when a super-majority is leaning in the same direction. The history of markets has countless examples, but I'll give one that's particularly relevant to bonds. Experts have been betting on a rise in Japanese bond yields for the last 20 years. That bet is often referred to as the "widow maker" among traders because so many have lost money betting against Japanese bonds.

That trade may work one day, but at this time Japanese 10-year yields currently hover between 0.5% and 0.75%, compared to 2.5% and 3.0% for U.S. 10-year bonds. I'm not suggesting the U.S. will follow Japan's deflationary path in the future; however, it's perfectly reasonable to expect U.S. 10-year rates to be range bound between 2.5% and 3.5% over the next 10 years.

When the consensus is so fully one-sided against an asset class, most investors and traders have already sold. In this case, the U.S. and foreign central banks have been the buyers of bonds. Many worry that bond yields must rise when quantitative easing ends or that foreign central banks will eventually sell their U.S. bond holdings. What most investors don't realize is that the bond market has priced in these sentiments.

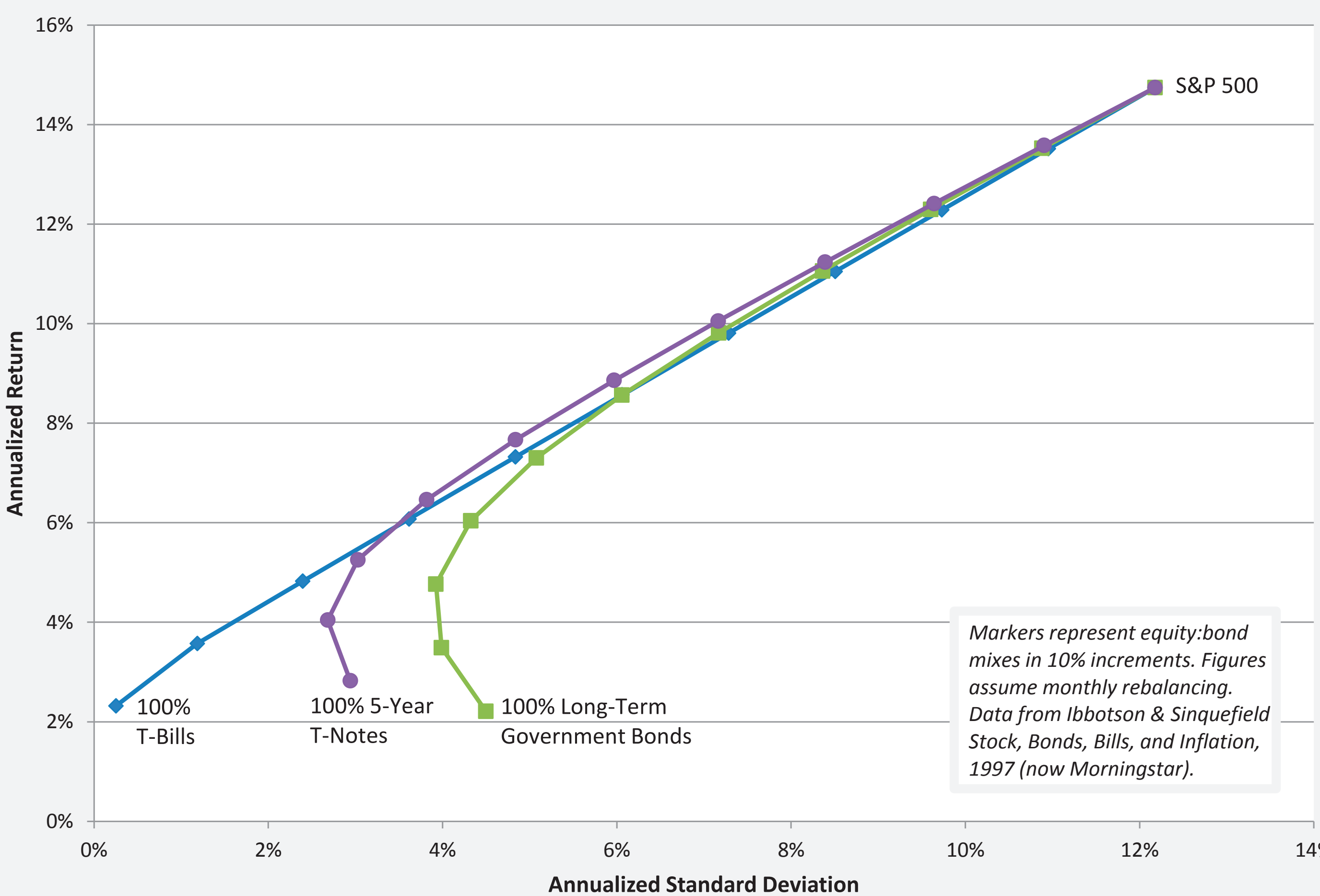
Portfolio duration of four to five years is optimal

The sweet spot duration for our investors is in the intermediate range of four to five years. The intermediate duration provides a nice compromise of offering overall portfolio stability, market crisis/deflation/recession protection, a long-term real return above inflation and the ability to quickly adapt to a rising rate environment. With this duration, we believe our clients don't have to worry about rising interest rates.

To show why, let's compare how intermediate-term bonds performed in a previous period of rising rates. As long-term investors, I have chosen to examine a decades-long period of rising interest rates rather than focusing on the individual cyclical periods of rising and falling yields. The time period is 1952 to 1982 where long-term interest rates rose from 2.7% to 11%. I also split the period into two time ranges: 1952 to 1964 and 1965 to 1982.

Figure 1 shows a comparison of three portfolios consisting of stocks (represented by the S&P 500) mixed with three bond portfolios consisting of 5-year Treasury Notes, 1-month T-Bills, and long-term government bonds. Each marker represents a different equity:bond split in 10% increments ranging from 100% bonds on the left to 100% stocks on the right side of the graph.

Figure 1. Slow Rising Rate Environment (1952-1964)



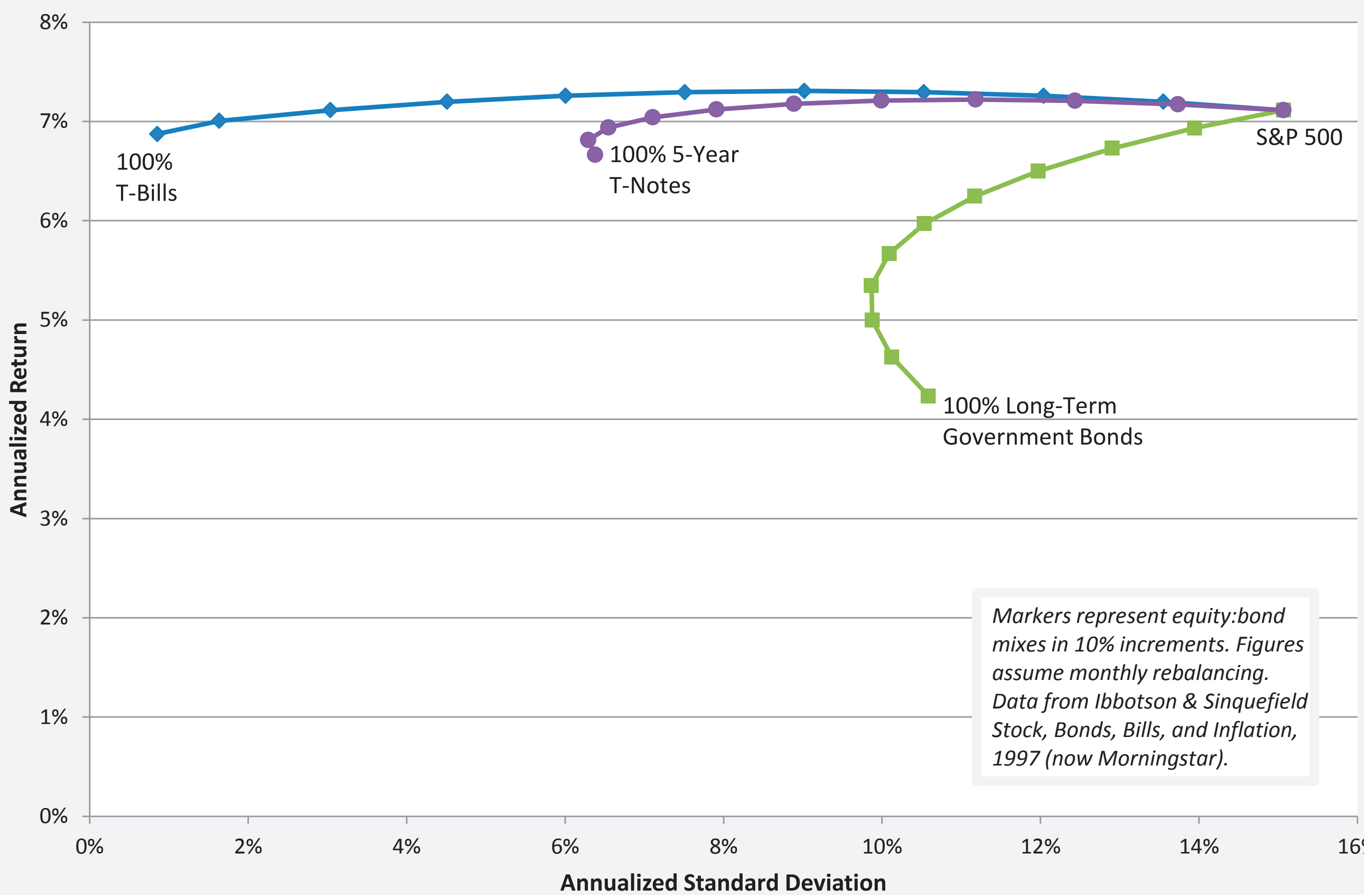
During the period associated with Figure 1, long-term government yields rose from 2.7% to 4.2% over 13 years from 1952 to 1964. Since this is a rising rate environment, and T-Bills have no interest rate risk, we might expect a portfolio of stocks and T-Bills to provide the best risk-adjusted returns. With similar logic, we expect a portfolio of stocks and long-term government bonds to provide the worst risk-adjusted returns because this portfolio has the highest sensitivity to rising interest rates.

This is indeed the case for a portfolio consisting of 100% bonds (see the data points at the bottom left). However, in this rising rate environment, the T-Bill portfolio was only best for equity:bond splits of 20:80 or lower, which is an uninteresting region for our clients. For equity:bond splits of 30:70 and higher, the 5-year T-Note portfolio provided the best risk-adjusted returns. The 5-year T-Note portfolio, simulated by Ibbotson and Sinquefield, has a duration in the 4 to 5 year range consistent with our core bond portfolio. Even though rates rose over this time period, the higher yield compensated for the slight negative impact on bond prices.

Figure 2 shows a much tougher environment for bonds. During this period, long-term government bond yields rose from 4.2% to 11%, and as expected the mix of stocks and T-Bills did best at all equity:bond splits. Holding long-term government bonds was clearly a bad choice. However, the 5-year T-Note portfolio actually performed quite well, providing risk-return profile that was very close to the T-Bill portfolio.

We also find that in falling rate environments, the 5-Year T-Note portfolio tends to be closer to the long-term government bond curve than the T-Bill curve. Without having to predict what interest rates will do, intermediate-term bonds turn out to provide a decent approximation of what will be best in the future.

Figure 2. Rapid Rising Rate Environment (1965-1982)



Markers represent equity:bond mixes in 10% increments. Figures assume monthly rebalancing. Data from Ibbotson & Sinquefield Stock, Bonds, Bills, and Inflation, 1997 (now Morningstar).

Rising rates signal an improving economy

Finally, rising interest likely coincide with an economy that is improving, which is generally good for stocks. Yes, temporarily, bonds will lose value due to rising yields. However, we expect only single digit losses from our bond portfolio, not the "bloodbath" that some pundits seem to think will happen. These losses are barely a mosquito bite compared to how fast equities and high-yield bonds can fall in value.

An intermediate-duration bond portfolio allows for significant reinvestment of coupons and maturing principal at higher yields, which leads to higher future bond returns and an improved probability of meeting investment goals.

We do worry that our current yield is barely keeping up with inflation, although the effective pre-tax yield of municipal bonds is pretty good for taxable accounts. We've shied away from replacing government bonds with higher yielding bonds, instead choosing to patiently live with the low-yield environment for the sake of diversification and safety. Stretching for additional returns in high-yield bonds can be done sparingly and judiciously, but can't replace our core high-quality bond portfolio because high-yield bonds suffer large losses during equity bear markets.

The Fed is being very deliberate in their path to normalize rates and safely wean the economy from the extraordinary measures taken since 2008. In short, we should be rooting for higher bond yields because it signals a healthy economy and higher bond returns in the future.