

# INVESTMENT BULLETIN

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## Did Interest Rates Just Turn?

Uncle Sam borrows for next to nothing. The government's cost for a ten year loan was just 1.7% at the end of April. In fact, ten year debt has been priced at 4.0% or lower since the financial crisis exploded in October 2008. In May and June, however, we observed a rapid move in Treasury rates to 2.5%. The spike drove the Barclays Aggregate Bond Index, the industry standard benchmark, to its largest one month loss (-1.8%) since October 2008. Without careful attention to the make-up of a bond portfolio, unfortunately, we think these negative surprises will become more frequent.

The challenge is, without the advantage of decreasing interest rates and perhaps with the headwind of rising rates, how does one earn risk-adjusted return in the bond sectors? We've written about some of our thoughts on rising to this challenge before (see the January 2013 *Bulletin* on catastrophe bonds for instance), but want to go into detail about the problem and explain our strategy for surviving it.

### Duration is a Double-Edged Sword

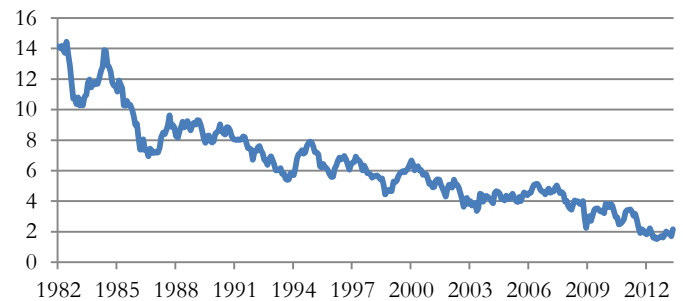
The best to place to start is with the concept of duration. The word sounds like it describes the length of time until a bond matures, but is better thought of as a measure of sensitivity (although for many fixed-rate bonds time to maturity and duration are closely related). You may have heard of the concept of beta as it relates to the stock market: it is an estimation of the price movement of a stock in proportion to the movement of a broader index such as the S&P 500. Duration is similar: it is an estimate of the price movement of a bond in proportion to the change in the level of interest rates.

This is an important measure of sensitivity because interest rate risk, in addition to credit risk, is one of the key risk factors assumed by bond investors. To see why, consider how a bond is priced. The economic benefits to holding a conventional fixed rate bond are twofold: the stream of interest payments and repayment of principal at maturity. The market discounts these future cash flows back to the present using the current level of interest rates. The discounting equation puts the prevailing interest rate in the denominator. So you divide by a larger (smaller) number if interest rates are higher (lower) thus decreasing (increasing) the value of the bond.

This is not a do-it-in-your-head calculation. Instead of discounting a long list of interest and principal payments using different interest rate scenarios, investment professionals use duration as a simple approximation of the change in bond price given a change in the level of interest rates. Each unit of duration represents the price de-

crease, in percent, you would expect if the level of interest rates rose by 1%. If a bond's duration is 5, you would expect a 5% price decrease if rates rose 1% and a 7.5% decrease if rates rose 1.5%. Of course it works both ways – you would expect the bond to *increase* in value by 5% if rates *decline* by 1%.

**Figure 1: What a Thirty Year Trend Looks Like**  
Ten Year Constant Maturity Treasury Yields, %  
Source: Federal Reserve



In fact, the latter has generally been the case for thirty years now. See Figure 1 for an illustration of the direction of ten year treasury rates since 1982 – almost an uninterrupted downslope. Most bond funds in existence today have not had to manage through a period of sustained rising rates.

**Figure 2: Deconstruction of Barclays Aggregate Bond Index Returns, %**  
Source: Morningstar

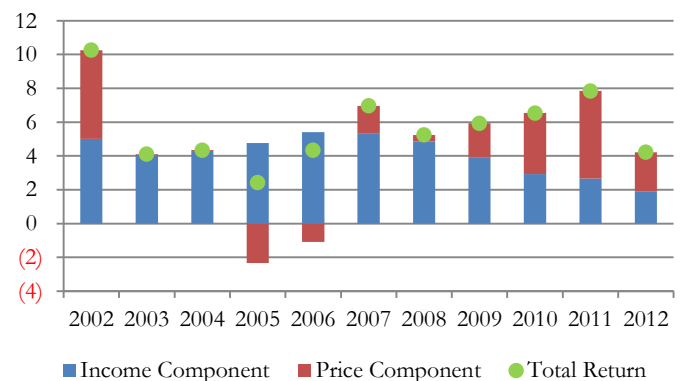


Figure 2 shows how much this trend has helped fixed income returns. The blue bars show the interest generated by the constituents of the Barclays Aggregate Bond Index (Lehman Brothers Aggregate Bond Index prior to 2008). The income component produced a steady return of around 4-5% in the years before the crisis, an amount that has gradually decreased in the years since. The reason the Index has been able to annualize at 5.6% on a total return basis is the contribution from bond price appreciation (red bars). In some years the contribution has been quite large, and in only two has it

been negative. This is due in part to the tailwind of decreasing interest rates. The tailwind cannot continue forever; if nothing else stops it, the fact that rates cannot go below zero will.

### ***Rates Have Been Low for Years, Why Turn Now?***

Many of the normal triggers for rising rates are absent. Consumer prices reported by the Bureau of Labor Statistics are growing very slowly, just 1.4% year over year. Further, the economy is expanding at a below average pace: 2.4% annualized in the first quarter per the Bureau of Economic Analysis. Without significant growth or inflation, normally you would not expect a pickup in rates.

However, there is the matter of the Fed's unprecedented intervention in the bond markets...and when it might end. The minutes of their meeting on April 30 - May 1, released on May 22<sup>nd</sup>, waffled a bit on their commitment to quantitative easing. The Fed opened the door to tapering the policy "if the economic information...showed evidence of sufficiently strong and sustained growth."

Chairman Bernanke reiterated the Committee's pattern of thinking in testimony before Congress on the same day the minutes were released. His comments after the June 18 - 19 Fed meeting had a similar thrust. This has spooked the bond market as investors are rushing to move out before support is removed. In the blink of an eye, we got a spike in the ten year yield to 2.5% and a loud thud from the Barclays index (down 3.2% in May and June to the 20<sup>th</sup>).

### ***Don't Buy the Index***

We believe some asset classes are most efficiently accessed through a broad index product (US large company stocks for instance). We do NOT believe that is the case with fixed income. The iShares product that tracks the Barclays Aggregate Bond Index (AGG) is heavily weighted to US treasuries and mortgages. (We don't mean to pick on iShares; all index products that track the Barclays Aggregate Index have similar characteristics). The main risk to owning US treasuries and mortgages is the risk that interest rates increase.

Our portfolios are designed to blunt the impact of rising rates. This is carried out in two ways: 1) we seek to minimize duration in the portfolio by overweighting managers that purchase shorter-term debt, that use interest rate derivatives to hedge duration, or that buy floating-rate debt (bank loans); and 2) shift the risk in the portfolio

from interest rate to credit, for which we think investors are better compensated. We compare and contrast against AGG in Table 1.

**Table 1: How Our Managers Differ**

*Sources: Manager reports*

	Avg of <u>Mgrs</u>	<u>AGG</u>
Yield	2.4%	2.1%
Duration	2.6%	5.0%
<i>Sectors</i>		
US Government	14%	39%
Agency Mortgages	9%	35%
Corporate	34%	21%
Bank Loans	15%	-
Cash	19%	2%
Other	9%	3%
<i>Credit Quality</i>		
Investment Grade	63%	99%
High Yield	37%	1%

Our expectations for this group of managers is that they will be half as sensitive to rising rates compared to owning an index product. A 1.0% increase in rates, all else equal, would drive prices in our bond portfolio down only 2.6% whereas an index product would be in the hole double that figure. The chief risks to our approach, relative to owning the index product, are that interest rates continue to fall or that high yield corporate debt sells off for reasons unrelated to interest rate increases. In view of Chairman Bernanke's comments on June 19, we see the credit risk from owning corporates – with a current default rate of only 1.0% and strong balance sheets – a better bet than buying an index with higher duration and hoping the Fed keeps a lid on rates.

Each of the managers draws on their own specialties to contribute to this calibrated mix. One, in particular, currently has a higher concentration to interest-rate sensitive government bonds. Our expectation is for that manager to improve the diversification of our bond portfolio, but if we feel interest rates are going to run away from them and don't see them adjusting, we would look to sell that manager thereby further reducing rate risk in our fixed income lineup.

You may have noticed that we have not yet answered the question posed by the title of this report. Our view is that interest rates will rise from current historical lows, but the short-term will be heavily influenced by Fed policy. A diversified fixed income portfolio that is not dominated by interest rate risk represents an investor's best shot at maximizing risk-adjusted returns in this environment. □

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