Rates They are A-Rising – How to Invest in Today's Bond Market

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Bond yields have fallen dramatically since the 2008 credit crisis, driven largely by Federal Reserve policy. The Fed's ambitious quantitative easing (QE) programs have stabilized the economy by infusing liquidity, yet distorted the demand for many types of securities through aggressive, open-market purchases of financial assets. The Fed has now stated its intent to begin cutting back its monthly purchases which peaked at $85B a month, reducing its target purchases down $10B a month in both December 2013 and January 2014. Rates, long held artificially low due to technical vs fundamental factors, may be poised to rise given this dreaded "taper." A rise in rates generally means a decline in bond values. However, no one has the Fed's inside view of the proverbial financial crystal ball. Any recent snippets of economic distress have been met with a flight to quality, sending Treasuries rallying. Which risk should investors focus on - interest rate, credit, business cycle, economic, emerging market?

Many would say the best way to make money in the bond market is to not invest in it. However, this short-sighted advice does not appreciate the key role fixed income investments play in a diversified portfolio. Note that even in the case of the bond bear market of 2013, total return was -2.04% as measured by the Barclay's Aggregate Index. The historically worst twelve-month return for bond investors was back in 1974, when the index fell -13.9%. This is clearly not the same or as frequent a rollercoaster ride as investors experience in the equity markets, where a classic bear market is defined as a price decline of 20%. Many investors remember the type of plunge we saw in October 1987, the 2000 dot.com bust and the 2008 financial meltdown.

Keep your eye on what bonds deliver – diversification, stability, and a steady income stream. Bonds have been traditionally less volatile than equity markets, allowing you the comfort of sleeping more soundly at night. If a bond is held to maturity you know exactly what you are getting absent any default/credit restructuring. So what to do now?

First, make sure your bond allocation is where you want it. The New Year and current market chaos offer investors the perfect opportunity to assess where they are. Perhaps you loaded up on fixed income investments post the 2008 banking crisis to capitalize on the bond market rally, but never rebalanced. You then found yourself over allocated and saddled with a negative return in 2013. Perhaps you jumped on the equity band wagon and following the 2013 rally, have very little fixed income exposure in your portfolio. Rebalance, make changes to your target allocation, do what suits your investment horizon and lifestyle. Remember, for the long-term

investor who is looking to diversify assets, generate an income stream, and who is able to wait out the short-term interest rate movements, bonds hold a valuable place in your portfolio. So what are some options for avoiding the pain of a potential rise in interest rates?

Keep it short – First, a quick lesson in bond math. Duration is the measure of a bond's price movement in response to a change in rates. Figured in the calculation is the time to maturity and the time it takes for a holder to receive all payments from a bond. A shorter duration generally equates with less interest rate risk and more protection to principal. Bonds with a shorter maturity date, all else being equal, have a shorter duration than longer term bonds given the horizon of the interest paying period. Higher coupon bonds also have shorter duration given that the bond is repaid at a higher and faster rate. Floating rate bonds, which reset interest payments frequently, will also have shorter duration. Conversely, a zero coupon bond that only pays interest at maturity will have a longer duration than a bond making semi-annual payments and will be very volatile in a rising rate environment. You can protect your portfolio by creating shorter duration through purchases of shorter maturity, higher coupon, or floating rate issues.

However, a shorter duration strategy often results in lower yields and income streams. If you need current income this will be a problem; in a rising rate environment this income may not keep up with inflation.

Diversify – Different types of securities react differently to rising rates. Historically, corporate notes (including high grade, high yield, and floating rate) tend to offer more interest-rate protection than government debt as the spread between Treasury yields tends to narrow in the face of an improving economy and credit fundamentals. The trick now is ascertaining if today's rising rate environment is being driven by an improving economy or technical matters resulting from the unwinding of QE. In any event, a diversified fixed income portfolio should perform better than one positioned exclusively in U.S. Treasuries.

Take on incremental credit risk – within reason - Historically, bonds with relatively higher yields tend to bear the brunt of rising rates better than lower-yielding maturities. Higher yields create an income cushion against market value declines. Included in this category is non-U.S. guaranteed debt such as municipals, corporate investment grade and high yield securities. Historically, this has been because rising interest rates signal a stronger economy, which generally helps lower-quality issuers most. However, high yield bond yields and the spreads relative to Treasuries are now at historic lows, implying investors may not be picking up enough yield to compensate for credit risk. We continue to advocate high quality corporate bonds in the 10-12 year time frame that may be held to maturity by the long-term investor. Municipals offer another attractively valued opportunity.

Buy non-bonds that adjust to interest rates – Following on the higher-yielding theme is the concept of buying instruments that perform like bonds such as floating rate notes. Bank loans and leveraged loans are examples. These loans offer attractive yields often with less interest rate risk than high yield corporate bonds as their duration is very short and the coupon is reset monthly or quarterly. This offers protection in a rising rate environment. Often the loans are generally secured obligations that rank higher in the capital structure than straight corporate debt,

giving investors additional protection and realization in a liquidation. However, the underlying issuing entity is often a speculative grade company, so volatility and credit quality become significant issues. Given that corporate balance sheets remain historically healthy, this sector may be attractive.

Active management offers advantages vs indexing – During a rising rate environment, managers of bond funds are often stuck playing with a set deck of cards. Public debt issuance has crowded out that of private debt over the past few years, mainly as a result of accommodative monetary policy. The Treasury component of the Barclay's U.S. Aggregate Bond Index grew from 25% in 2006 to over 36% in 2012, with corporate debt increasing at a much smaller rate. Index funds have become heavily weighted with Treasuries. An actively managed portfolio will offer investors the opportunity to seek out non-Treasury issues with shorter duration and more credit upside.

Ladder your holdings – This strategy helps you prepare for rising rates by holding securities that mature in sequential years. As one bond comes due, the proceeds from this lowest rung can be reinvested in a longer-maturity, higher rung on the ladder, likely with a higher coupon as rates rise. This provides a higher income stream to buffer price erosion as rates rise.

Although investors may be tempted to bail on the bond market given the Fed taper policy, staying the course and selectively choosing your fixed income investments is the prudent action. You will be rewarded with the diversification and stable income stream fixed income can provide, while circumventing some of the more interest-rate sensitive sectors of the market.