# Fixed Income Market Comments

Ascent Investment Partners

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## Fixed Income Perspectives: Rising Rates and the Case for Bonds

Much of the commentary about fixed income investing in 2013 has revolved around the risks to bond investors from rising interest rates and the search for income opportunities in a persistently low-yield environment. Some market commentators have warned of the risk of the "bond bubble" bursting, and the resultant blood bath awaiting holders of bonds. Other voices have urged investors to move out of low-yielding fixed-income and into higher-yielding investments, such as high-yield bond funds or alternatives that invest in structured securities (mortgage-backed securities, leveraged loan-backed securities, etc.). Investors have been warned to avoid interest rate sensitive investments while at the same time being prompted to move allocations into high credit risk and/or high market risk securities that could show extreme volatility in rapidly changing interest rate environments. This report discusses how bond investors can weather choppy markets by buying and holding a high-quality, intermediate-term portfolio of individual bonds.

Our June 4 Fixed Income Perspectives discussed the risks associated with reaching for yield and the need for a conservative fixed income component in an overall strategic asset allocation. It discussed some of the considerations investors should weigh as they compare bonds to other income products that are offered as "yield enhancers." Since that publication, bond markets have dropped significantly on concerns that the Fed will begin to taper its quantitative easing (QE) program in the coming months. The yield on 10-year U.S. Treasury bonds – the most widely quoted indicator of bond yields – rose to 2.93% this week, its highest level in more than two years and up more than 1.25% (125 basis points) from the 2013 lows in early May. As bond yields have risen, investors have been running from fixed income products of many types. Since late May, money flows out of bond funds and fixed-income ETFs have been at levels not seen since the worst of the Lehman-triggered market disruptions of late 2008. As a result, fund managers are being forced to sell holdings to raise cash, locking in losses and pressuring share prices lower.

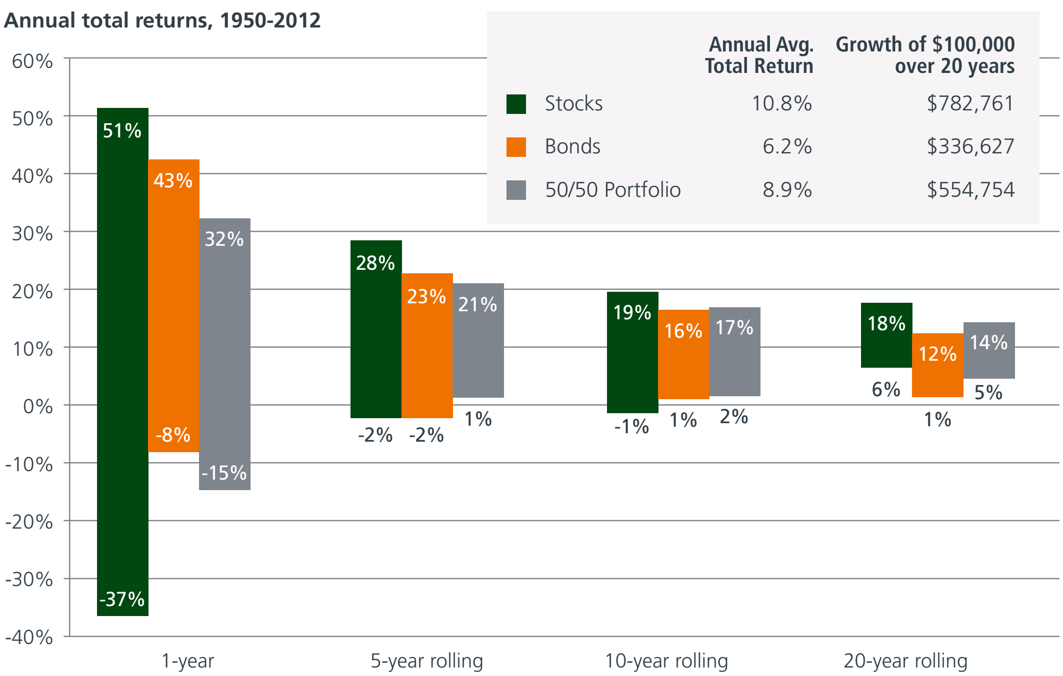
Given that bonds have suffered significant declines over the past three months, and given the expectation that Fed tapering of QE could continue to drive 10-year and 30-year rates higher, why would an investor want to hold bonds today? In an environment such as we are in today, in which historical correlations among asset classes could be breaking down and the uncertainty of changes in Fed policy is introducing volatility in all markets, it is more important than ever that investors have a measure of stability in their investment allocation to offset the potential for volatility in financial markets. For investors with an orientation toward income generation and wealth preservation, a core bond allocation provides a foundation that can significantly reduce uncertainty.

We believe there are compelling reasons for investors to continue to maintain a conservative fixed-income allocation within their overall long-term investment strategy. Furthermore, we view a portfolio of individual bonds as offering some significant advantages over bond funds, ETFs and other income alternatives in today's markets.

- With high quality individual bonds, investors know with a high degree of certainty that they will receive a known stream of income over a set period of time and full return of principal at maturity. Bond investors benefit from this certainty despite the potential for short-term unrealized losses if interest rates move higher.
- Over a long time horizon, fixed income provides a more stable source of return with less volatility than equities or other asset classes. Since 1950, bonds and equities in a blended portfolio have provided less volatile returns than equities alone over holding periods ranging from one to 20 years. (see chart below)
- With proper credit selection and surveillance, investors should never be faced with an interruption of payment or loss of principal from a bond default. High-yield bond funds and other riskier income investments can have advertised returns severely impaired, or even driven strongly negative, if they experience defaults or downgrades at higher than assumed levels.

## Range of Stock, Bond and Blended Total Returns

**Annual total returns, 1950-2012**




As of 6/30/13
Sources: J.P. Morgan Asset Management
Returns shown are based on calendar year returns from 1950 to 2012. Growth of $100,000 is based on annual average total returns from 1950-2012.

- In rising rate environments, bond portfolios can be managed more conservatively by shortening duration on purchases and raising credit quality even higher. To date in 2013, while rates on 10-year U.S. Treasury bonds have risen by 114bps, five-year Treasury yields have climbed 96 bps. Over the same period, two-year yields are up only 15bps and yields on 12-month and shorter Treasuries have actually declined. Since January 1st, the rise in the municipal rates has been even more heavily weighted to maturities beyond 10 years. (see chart below)
- A properly-laddered, conservative portfolio has bonds maturing on a regular basis at par. This provides investors with great advantages in volatile markets or when interest rates are headed higher:
    1. Rising rates allow the bond investors to dollar-cost-average the yield of their portfolio up over time, using maturing bond proceeds and interest income, without having to allocate new capital to the fixed-income allocation of their overall investment mix.
    2. If an investor needs to raise cash, there are always securities at or near maturity that can be sold at or close to face value. Unlike alternative income investments (dividend stocks, mutual funds, ETFs, structured products), investors are highly unlikely to be forced to sell securities at a significant loss or, worse, to be unable to sell investments when needed due to lock-up provisions or a lack of market bids.

### Increases in Bond Market Yields

**January 1, 2013 to Present**


Sources: Bloomberg; MMD; Ascent Investment Partners

Bond mutual funds, exchange traded funds (ETFs) and other alternative income securities (structured products such as CMOs, CLOs, etc.) have all been developed to provide investors with an income alternative that provides the investment benefits of owning bonds with enhanced market liquidity. While this may intuitively make sense, it is vitally important for investors to understand the key differences between owning individual bonds versus owning bond funds or equity-like products (ETFs, dividend stocks, etc.).

1. Individual bonds have a maturity date, at which time they pay back 100% of par value. Bond mutual funds, ETFs, equities and other investments are perpetual securities that never mature. There is no holding period for which an investor is sure to receive their entire investment back.
2. Bond funds, ETFs and similar structures typically employ leverage to boost returns. This boost works both ways. Leverage can increase returns in positive market environments, but it can also significantly decrease returns in negative markets.
3. The purported benefit of funds and ETFs – low transaction costs and market liquidity – actually work against income investors in volatile markets. Because they are easy to trade, investors tend to trade in and out of such investments based on short-term returns. As a result, prices of such securities tend to be far more volatile than for the underlying bonds they own because they are subject to selling pressures arising from outflows. Investors tend to sell these securities as prices drop, locking in losses and adding to the downward market price pressure.

In our previous report from June, we noted that carefully constructing an overall asset allocation is the most important investment decision an investor can make.  It is the engine that drives a portfolio's performance. In today's market environment, we believe that core fixed income still has a place as the foundation that helps protects the portfolio from the waves of volatility that we see roiling world financial markets.

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