

December 1, 2015

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Bond Investors Shouldn't be Spooked by the Fed

Will the Fed finally pull the trigger at its December meeting? The question of when the Federal Reserve Board will begin the process of raising benchmark rates has been hanging over financial markets throughout 2015. The timing of the first Fed tightening has been the single largest factor driving U.S. financial markets this year, with both bond and stock markets holding their breath to see if the Fed would move in March. And in June. And in September and October. In light of the October jobs report and the release of the minutes of October's meeting, the markets now seem convinced that a December move is likely. With each passing Open Market Committee meeting, and each failure to begin of the move away from historically low rates, trading volatility increases.

We think that, as the Fed makes the first moves toward normalizing the interest rate environment, bond investors are poised to benefit greatly. The conventional wisdom parroted in countless market commentaries is that bonds perform poorly in rising rate environments. As a result, market analysts and many financial advisors have been warning investors to move out of fixed-income investments before the Fed raises rates and their bond investments lose value. We believe that this advice is short-sighted and does not serve the best interests of most investors. It is akin to focusing on the tree and completely losing sight of the forest.

Ascent believes that the key to successful investing over the long term is establishing a sound investment strategy and sticking to it. A well-diversified investment strategy is designed to balance asset classes in order to manage long-term, total portfolio risk through changing market environments. Asset allocation should be driven by risk tolerance, investment horizon, and clients' individual needs and goals, not by chasing returns in high-performing asset classes or shifting among sectors based on forecasted future returns for coming quarters. Trying to time markets via a tactical approach to investment allocation rarely works. No asset manager or investor has been able to time the market correctly and consistently. For example, since 2013, almost all market observers and investment managers have been sure that the Fed would begin to tighten policy and that bonds would suffer. In each year since (including 2015 to date), government, corporate and municipal bonds have outperformed consensus projections.

To be sure, the Fed will begin raising rates at some point. However, whether that means December, next March, or later is not the key consideration. Rather than react by changing

the focus of their investment strategy, investors should examine their overall asset allocation to ensure that they are well-positioned to take best advantage of a rising rate environment.

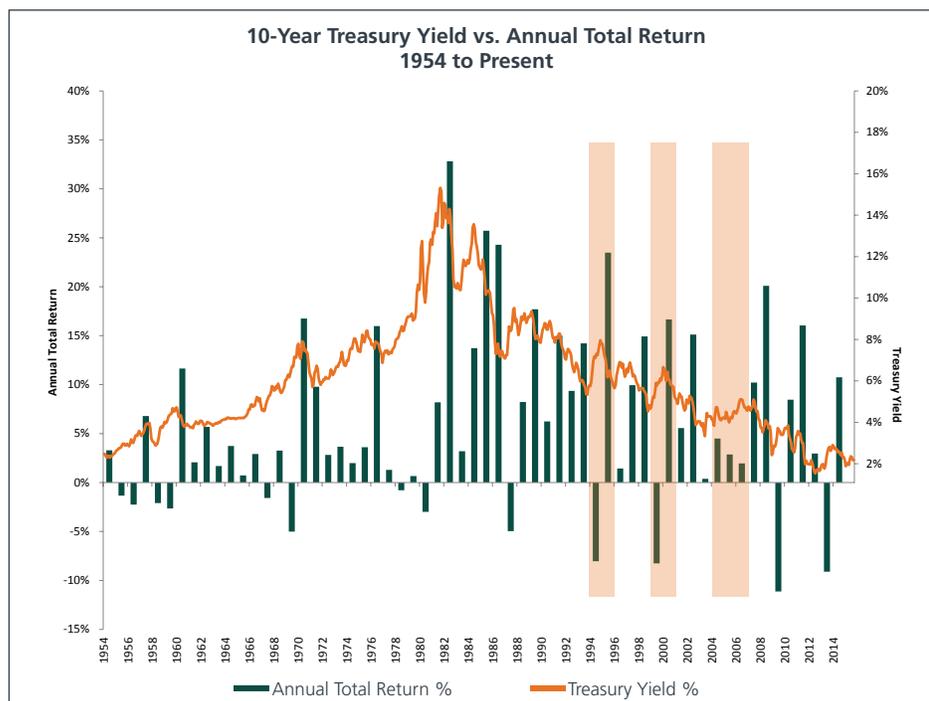
Since the Fed undertook unprecedented monetary stimulus, the common complaint from fixed-income investors has been that yields are too low. Over the past five years, investors have flocked from traditional fixed-income investments (investment-grade bonds, bank CDs, interest bearing accounts, etc.) to higher-yielding income alternatives (mortgage-backed securities, MLPs, junk bonds, CLOs and other leveraged loan structures, etc.). While these products have offered enhanced yield, they also expose investors to substantially higher investment risks. Over the second half of 2015, many of these higher-yielding alternatives have performed very poorly, as increased default rates and expectations of higher interest rates drove down market prices and liquidity. One benefit of rates beginning to rise is that investors will have the opportunity to realize greater income flows and higher yields from their high-quality fixed-income portfolios – just what they have been asking for. This increase in income can help compensate for any short-term declines in the prices of bonds held.

The chart on page 3 illustrates the monthly yield on the 10-year U.S. Treasury bond since 1954. Overlaid is a chart of the annual returns of the 10-year Treasury over the same time period. Periods since 1990 during which the Fed was raising rates are highlighted. This chart shows that even in a long-term rising-rate environment, such as from the early 1950s until the peak of yields in 1981, bond total returns were very rarely negative on an annual basis and generally performed well except for those periods of rapidly rising yields.

What are the realities of fixed-income investing in a rising rate environment?

- Investor returns in high-grade bonds have been positive over longer holding periods. While rising rates do have negative impacts on bond prices in the very short term, bond total returns have been positive over every rolling five-year holding period since 1981. While we would expect markets to react to a Fed rate hike via higher yields, (and falling bond prices), holders of individual bonds have an advantage in that this price impact is only on paper. They will continue to receive a known interest cash flow and the return of their principal at maturity. Investors in individual bonds only realize losses if they sell bonds prior to maturity, in contrast to those invested in bond funds or ETFs.
- The pace of change matters. Bond prices are more volatile in rapidly rising rate environments than when rate hikes are expected and are gradual. No one expects the Fed to move rates higher quickly, including the Fed itself. Though volatility has been increasing in 2015 as markets anticipate the Fed's first move, we expect volatility will decline somewhat once the first move is made as long as the Fed effectively telegraphs its policy to investors. After eight years of historically low rates, the Fed has clearly stated that it will move very slowly. When rate hikes have been gradual in the past, bond returns have been solidly positive.

- Portfolio structure matters. A laddered bond portfolio structured with a relatively short duration and high quality bonds can be expected to show the least volatility. Such an approach gives investors the opportunity to roll over coupon payments and maturing principal into higher-yielding bonds as rates rise.
- Liquidity is vital. As rates rise, many investors will try to exit bond investments to limit their losses. Our past experience shows that this is especially true for investors in mutual funds and ETFs, which are marketed in part based on their liquidity. Such selling can reinforce the downward pressure on prices, creating a value buying opportunity for investors in individual bonds. We expect investments with limited liquidity – mortgage backed securities, MLPs, leveraged loans, CLOs, and junk bonds, etc. – to face substantial losses due to low liquidity.
- Too much liquidity, however, can be a trap. Investors in fixed-income mutual funds and ETFs seek the benefits of holding bonds with the promise of enhanced liquidity. The potential pitfall of greater liquidity is that it makes it very tempting for investors to sell their fixed-income holdings in a weakening market. As investor money flows out of funds and ETFs, the funds are forced to sell holdings to meet withdrawals, further pressuring prices downward. The feedback loop of “lower prices triggers selling that drives prices lower” can make it difficult for investors to stick to their asset allocation when they hold funds and ETFs instead of individual bonds. The promise of easy liquidity can entice investors to sell to “limit losses” but they actually lock in real losses that buy-and-hold investors would not realize.



Sources: St. Louis Federal Reserve Bank; Ascent Investment Partners estimates and calculations

Perhaps counterintuitively, bond returns have proven to be relatively strong in recent rising rate environments. The table below shows the total return performance of 10-year U.S. Treasury Bonds during periods of Fed tightening over the past 35 years. Bonds showed a negative total return in the first year during only two of those three periods. More significant was the total return over the subsequent three-year and five-year holding periods. Despite negative year-one returns, bonds returned greater than 4% annualized returns for each three-year period during and after Fed tightening cycles. Those annualized returns jump to more than 5% per year over 5 years, with the 1994-1998 and 2004-2008 periods returning more than 7.7% annualized.

10-Year Treasury Bond Returns During Periods of Fed Tightening (1990 to Present)

	Feb. 1994 - Feb. 1995	June 1999 - May 2000	June 2004 - June 2006
Starting Fed Funds Rate	3.00%	5.00%	1.00%
Ending Fed Funds Rate	6.00%	6.50%	5.25%
Number of rate increases	7	6	17
Total rate increase	3.00%	1.50%	4.25%
Year 1 annualized total return	-8.04%	-8.25%	4.49%
3-year annualized total return	4.82%	4.16%	3.10%
5-year annualized total return	7.79%	5.48%	7.72%

Sources: Bloomberg; Federal Reserve Bank of New York; Ascent Investment Partners estimates and calculations

Over the short term, long maturity bonds can be expected to lose significant book value in rapidly rising rate environments, however, bond returns have almost always been positive over three-year, five-year and 10-year holding periods since 1954. Shorter duration, laddered bond portfolios, such as those managed by Ascent, are an effective way to help benefit from the stability of bonds in volatile markets. The longer maturity bonds in the portfolio maintain yield through a market cycle, and the shorter maturity bonds create a defensive position that allows investors to reinvest maturing principal. In contrast, mutual funds and ETFs can expose investors to significant volatility and price risk independent of the credit strength of the underlying portfolio. When the Fed begins the process of raising rates, bond prices will feel the effects. However, Ascent's approach to fixed-income portfolio investing allows investors to remain true to their asset allocation strategy while best positioning them to take advantage of rising rates, thereby enhancing the likelihood of fixed-income cash flows and longer-term total returns.



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