

What happens to bonds if interest rates rise?

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Investors in search of the safety and income offered by bonds may not be aware of what happens if interest rates rise as they have done over the last six months. Having reached a low yield of 1.39% in July 2012, the current yield on the 10-year U.S. Treasury bond is 1.87%. If an investor purchased the new 10-year U.S. Treasury bond issued on November 15, 2012, the return through February 13, 2013 would have been -3.83%. Given its coupon yield of 1.65% at purchase, this principal loss would be equal to two and a half years of interest payments.

In a time of low interest rates, our approach at Cambridge Trust has been to identify corporate bonds with higher coupons and shorter maturities that will soften the blow from rising rates. For example, many of our client portfolios hold Goldman Sachs 6.25% bonds which mature in 2017. During the same time period of the example given above (11/15/12 to 2/13/13), the Goldman Sachs bond had a total return of +2.16%.

Investors in long duration bond mutual funds need to pay particular attention to the possibility of rising interest rates. Since bond mutual funds do not have a defined maturity date, a prolonged upward move in interest rates would compound the expected losses. This differs from owning individual bonds, in which an investor would receive par value at maturity, notwithstanding any credit event.

Since the financial crisis began in 2007, the Federal Reserve (Fed) has implemented many programs to help stabilize the markets and encourage economic growth. Beginning in December 2008, the Fed began the first

10-Year U.S. Treasury Yield



Source: Bloomberg

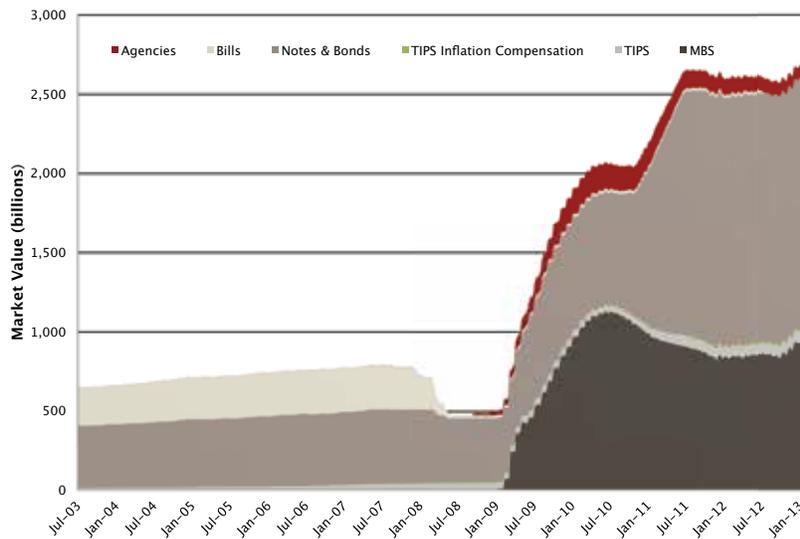
round of quantitative easing with purchases of \$600 billion in agency mortgage backed securities (MBS) and agency debt. Quantitative easing is an unconventional monetary policy in which the central bank makes outright purchases of financial assets from banks and other private institutions. In March 2009, the Fed added an additional \$750 billion in MBS and agency debt plus \$300 billion in U.S. Treasury securities. In November 2010, the Fed initiated the second round of easing (QE2) and announced the purchase of \$600 billion in longer dated Treasuries. QE2 ended in June 2011. In September 2011, the Fed announced the implementation of Operation Twist whereby the Fed would purchase \$400 billion of bonds with maturities of 6 to 30 years and sell bonds with maturities of less than 3 years, thereby extending the average maturity of their portfolio. On June 20, 2012, the Fed extended Operation Twist by an additional \$267 billion through the end of 2012. On September 13, 2012, the Fed announced a third round of quantitative easing (QE3) which provided an open-ended commitment to purchase \$40 billion per month of MBS and, finally, on December 12, 2012 the Fed added \$45 billion per month

What happens to bonds if interest rates rise? *Continued*

of Treasury securities. All told, the balance sheet of the Federal Reserve Bank has increased by over \$3 trillion. The Fed has funded these asset purchases through the creation of Federal Reserve notes on its balance sheet (also referred to as “money printing”).

The ultimate goal of all these programs is to stimulate economic growth and employment while keeping

Composition of Fed Balance Sheet



Source: FTN and Cambridge Trust Company

interest rates low. There is considerable debate over whether the Fed has over-stepped the boundaries of traditional monetary policy via outright asset purchases; nevertheless, interest rates have been on a downward trend. In December 2008, the 10-year U.S. Treasury was yielding 2.74% and reached an all-time low of 1.39% on July 24, 2012. The bull market in bonds goes back ever further. In September 1981, the 10-year U.S. Treasury was yielding 15.84%. During this period of falling interest rates, long-term Treasury bonds have

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returned over 11% annually. With modest returns and increased volatility from stocks over the past decade, investors have increasingly sought the safe-haven of bonds. Since 2007, almost \$1.2 trillion has been invested in bond mutual funds while at the same time \$459 billion has been withdrawn from equity mutual funds.

The main objectives of investing in bonds are to protect

principal and ensure a steady and dependable income stream. These objectives remain the same. Bonds are still an important asset class and a means to help reduce volatility in portfolios. We have been conservative in our approach to fixed income investing. As we have written in the past, we have managed client portfolios with a shorter duration than the benchmarks. The shorter duration will help to reduce the interest rate sensitivity and protect principal when interest rates rise. Additionally, shorter maturities afford us the opportunity to reinvest maturing bonds into higher yielding securities once rates increase. If the economy improves, the yields on

corporate bonds should offer a better total return alternative than Treasuries. Corporate balance sheets are strong and do not face the daunting task of refunding \$16 trillion in debt as does the U.S. Government.

We still favor corporate bonds and will continue to manage portfolios with average durations of close to 4.5 years rather than the Barclays Government/Credit Index benchmark duration of 5.83 years.

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