



Five Strategies for a Rising Rate Environment

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June 8, 2010

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The Federal Reserve can't accommodate forever, and the global stimulus effort will likely lead to inflation. Our growing indebtedness can only result in increased borrowing costs.

That much we know. What we don't know is when and how quickly interest rates will rise.

Consider the differing opinions of two of the world's largest investment banks. Goldman Sachs doesn't foresee a rate change in the U.S. until 2012 and is forecasting a 3.25 percent 10-year Treasury yield at the end of this year. Compare that to the 4.5 percent 10-year Treasury yield that Morgan Stanley is forecasting and you have two firms disagreeing not only about the timing, speed and shape of the yield curve, but also on the fate of the U.S. economy.

So, what are we to do? On the timing front, it's anybody's guess. Up until the end of April, Morgan Stanley was anticipating a rate hike in September, but it has now pushed its prediction back to early 2011. Morgan Stanley had also forecasted an end-of-year Treasury yield of 5.5 percent in April, which it dropped an entire percentage point when Europe's sovereign debt issues and contagion fears came to a head.

On the investment front, advisors have at their disposal the usual technique of shortening bond maturities to dampen losses caused by increasing interest rates. But your investment strategy shouldn't end there. We propose five additional strategies to protect further against rising rates and inflation – strategies that also diversify and improve the strategic positioning of a portfolio.

1. Ultra-Short Bonds: Lengthen cash and shorten short-bonds

Many advisors are used to short-duration bond funds that target a one- to three-year duration, but in our experience they often steer clear of ultra-short strategies. Ultra-short bond funds target a much shorter duration, typically between 0.5 and 1.5. (The "ultra" in the strategy's name doesn't refer to leverage.)

Ultra-short bonds have two main advantages: diversification and yield.

An ultra-short strategy diversifies and can even fine-tune your duration target. An advisor using only a short bond strategy and a total bond market strategy is limited in his or her



duration range. For example, the Vanguard Short-Term Bond ETF (BSV) has a duration of 2.6, and the Vanguard Total Bond Index ETF (BND) has a duration of 4.5, according to Morningstar, Inc. (as of 4/30/2010). An ultra-short fund would allow an advisor to bring average overall duration down in a more substantial way.

Many ultra-short funds offer a decent yield compared to the near-zero yield you get on most money market funds today. By moving slightly out on the yield curve, you can pick up more than 1.4 percent in yield. Obviously, ultra-short funds are not money market funds, and their prices will fluctuate, so the strategy you select matters greatly.

Ultra-Short strategy considerations

We recently added RidgeWorth U.S. Government Securities Ultra-Short Bond (SIGVX) to some of our more conservative portfolios. We selected this strategy for its use of government securities, its focus on NAV volatility and for its fees (0.32 percent expense ratio according to Morningstar, Inc.). This fund is focused first on trying to maintain a stable NAV and then generate yield. In our most conservative portfolio, we allocated half of our money market allocation to this strategy (we went from 13 percent to 7 percent money market with the difference in ultra-short bonds).

2. International Fixed Income: Putting more variables into bond mix

Through currency movements and higher yields, international and emerging market debt can serve a portfolio well when rates rise. While the U.S. dollar may now be in a cyclical bull phase, the longer-term trend looks like a secular bear market, since our rapidly increasing debt-to-GDP ratio will most likely lead to higher borrowing costs and a weaker dollar. Obviously, that benefits international investments, since the decreasing dollar becomes an additional source of return for U.S. investors.

We aren't alone with our high debt-to-GDP problem. Many mature, developed nations have huge debt burdens that will lead to higher borrowing costs and slower growth. The U.K. comes to mind, and the PIIGS (Portugal, Ireland, Italy, Greece and Spain) of Europe have put the value, even the viability, of the euro in question.

On the other hand, many developed and emerging countries remain in excellent health and have avoided the massive debt accumulations of mature countries. While they may not be considered developed or even high quality, from a fundamental perspective (i.e., they can pay their debts) many of their balance sheets and GDP growth rates are very respectable. Investing in multiple markets also contributes to diversification, since most fixed income strategies used by advisors are exclusively U.S.-based.



International Fixed Income strategy considerations

When making the allocation decision to use international bonds, you'll need to determine if developed, emerging or both markets are right for the portfolio. In any of these markets, we use unhedged or selectively hedged strategies, since we view currency exposure as a diversifier and potential return enhancer.

Our preferred choice for international fixed income is Oppenheimer International Bond Fund (OIBAX) as it invests in both developed international and emerging markets. If you are looking to keep the number of positions you use in your portfolio low while providing good diversification, this is a two-for-one option. For emerging markets, we use PIMCO Emerging Local Bond (PELBX), which invests primarily in local markets, so you experience the currency fluctuations.

3. Floating Rate Bank Loans: Short duration and adjustable yield

With high-yield bond spreads back within their historical range, we have seized the opportunity to realize some of the gains we experienced and directed them to something better positioned for rising rates. While high-yield bonds still provide a healthy yield that should help offset their falling prices in the wake of a rate increase, the time for easy money from this asset category has passed.

Most floating rate bond funds use senior bank loans that have been securitized and are similar in credit quality to those of high-yield bonds. Bank loans are higher in the capital structure than high yield bonds, so in the event of a default, bank loan holders typically get paid back first. A major difference between floating rate funds and typical high-yield funds is that floating rate loan yields will adjust with changes in LIBOR. With the recent doubling of LIBOR, the yield you receive from these funds goes up. These funds are also typically very short in duration so your principal has less interest rate exposure.

Floating Rate strategy considerations

Last year, we introduced both high-yield and floating rate bonds into our models. This year, we favor floating rate over high-yield exposure for new allocations and are systematically reducing our high-yield exposure. We currently use Fidelity Floating Rate High Income Fund (FFRHX) with a 30-day SEC yield of 3.45 percent and a weighted average maturity of 3.96 years (source: Morningstar, Inc. as of 4/30/2010). This fund exhibited lower volatility when compared with most peers over the past several years, and we feel that a more conservative, consistent investment approach is preferable with lower-quality rated securities.



4. TIPS: Good for inflation and inflation expectations

As the only strategy with a direct tie to the Consumer Price Index (CPI), Treasury Inflation-Protected Securities (TIPS) are a natural place to invest if you are concerned about inflation. As the CPI rises, the principal on TIPS adjusts upward. In return for this feature, investors give up some yield. With current inflation all but non-existent, the CPI contribution is minimal.

TIPS prices respond more to inflation expectations than to actual inflation. For example, when inflation expectations were low in 2008, TIPS went lower. When expectations about inflation increased as the economy and stock market started to recover, TIPS also increased in value. Actual inflation during this entire time period was very tame and relatively constant.

Currently, we don't advise overweighting TIPS or using TIPS as your sole inflation-fighting strategy for two reasons. First, TIPS' investors bid up their prices late last year when concerns related to future inflation began to circulate. Second, you could suffer a holding-period total-return loss even if you correctly timed your purchase. A total return loss is possible when rising interest rates decrease your principal and the low real yield and inflation adjustments are not sufficient to offset the price decline.

TIPS strategy considerations

We have used iShares Barclays TIPS Bond Fund (TIP) for some time and prefer it because its duration of 4.93 is shorter than most total market TIPS funds. For a short TIPS strategy, look to PIMCO 1-5 Year U.S. TIPS Index Fund (STPZ). The 2.61 duration is almost half the duration of TIP (source: Morningstar, Inc. as of 4/30/2010). For our actively managed strategies, we use PIMCO Real Return (PRRDX), which uses a variety of techniques to enhance return while controlling interest rate risk.

5. Real Assets: Participate in a recovering global economy

Natural resources and commodities offer good inflation protection and also help diversify your overall portfolio. If you have been hesitant about using them in the past, there are many compelling reasons to use them in a rising rate environment.

Historically, commodities have performed well when rates increase. From 1976 to 2009, the average return for the S&P Goldman Sachs Commodities Index was 18.5 percent in years when interest rates rose. Compare that to the S&P 500 Index average return of 8.8 percent and the Barclays Capital U.S. Aggregate Index of 4.7 percent (source: DWS Investments analysis using Morningstar, Inc. data as of 12/31/2009). The driving factors behind increasing rates are highly correlated to the driving factors behind commodities returns.



Real Assets strategy considerations

ETF advancements over the last five years have expanded access to natural resources and commodities. We added SPDR Gold Trust (GLD) to our tactical models last year as we were wary of inflation and worried about the strength of fiat currency globally. Since GLD holds physical gold, it is taxed differently (as a collectable) than other funds, but we don't feel that should limit its use since there is nothing else like it. To bypass the higher collectible tax rates, use this holding in tax-deferred accounts.

For commodities exposure, we prefer a mutual fund that recently switched its structure to a more quantitative approach. DWS Enhanced Commodity Strategy Fund (SKSRX) takes advantage of the popular Deutsche Bank Liquid Commodities Indices (DBLCI) strategies, but it takes a more diversified approach by using the Dow Jones-UBS Commodity Index as the backdrop. To enhance return, the fund uses mean-reversion, optimal-yield placement (this is important since an inflexible trading policy coupled with a commodity in contango is a drag on returns), and a momentum strategy that has the ability to allocate to cash (up to 50 percent) should the market start to free fall.

The Time for Action Is Now

While we watch with anticipation to see when the Fed will drop its "extended period" language, the strategies above can prepare your clients' portfolios for rising rates and the economic factors that will precipitate the increase. As with most successful strategies, you have to take action early to realize the true benefits.

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