

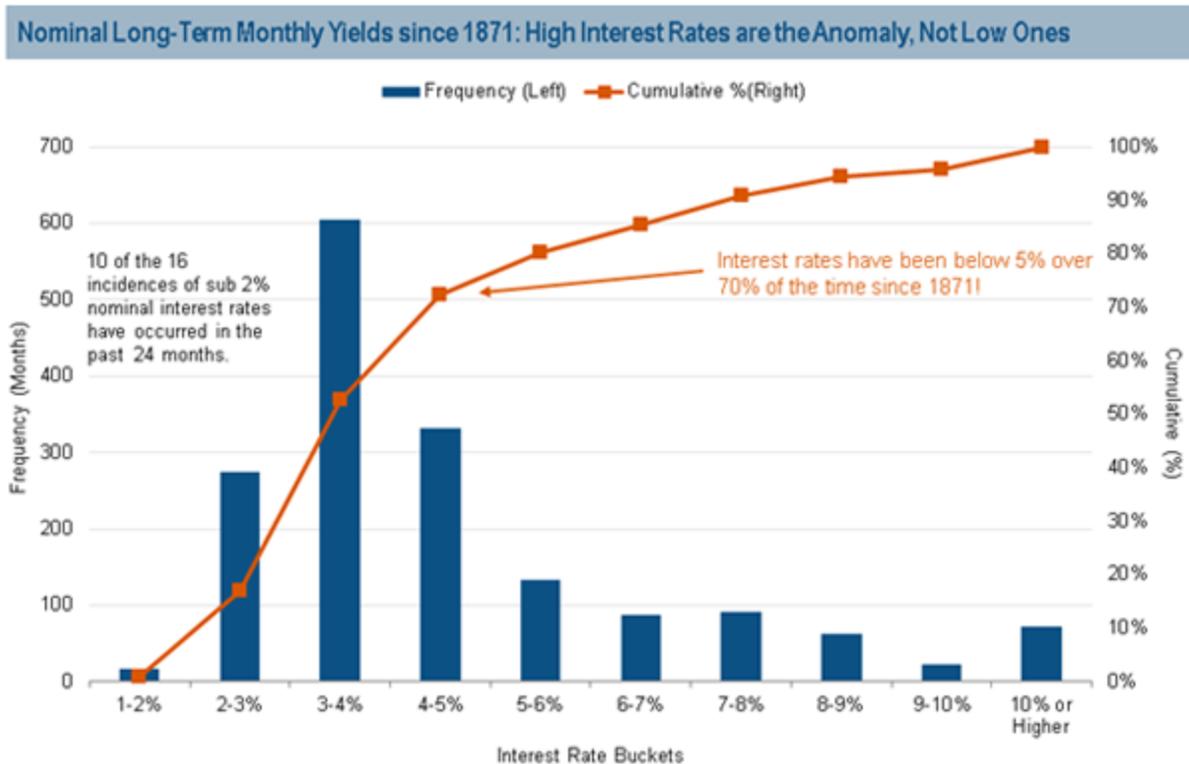
# Bond Strategies for Rising Rate Environments

By: Jim Sarni and Peter Beer of Payden and Rygel

## Whither Bonds? The Role for Fixed Income in Portfolios in a Rising Interest Rate Environment

The yield on the 10-year US Treasury rose more than 1.3% over the summer of 2013. The prospects of returning to higher yields too quickly have many fixed-income investors worried. Inquiring minds want to know: how can we adjust portfolios for this rising rate environment?

It is important to put the recent increase in interest rates in a broader context. For the past 3 years, interest rates declined and now hover near historic lows. In 2012, the yield on the 10-year Treasury note averaged 1.8%, the lowest in half of a century. While future increases in interest rates are highly likely, the magnitude and timing of the potential rate rises are key considerations. If history is any guide, we should welcome an adjustment to 3-4% yields. Such an adjustment moves yields closer to more "normal" levels (See Chart Below).



Source: Robert Shiller

Note: Nominal interest rates for 10 year US Treasury Note; prior to 1953 nominal interest rates for longer-term US Treasury bonds.

However, a move back toward mid-single digit interest rates is not necessarily the next step on the way to dramatically higher, double digit interest rates (think late 1970s, early 1980s). Structural factors like the disconnect between growing investor demand for income and the shrinking supply of income generating investments is a force helping keep interest rates low. Especially in the safest asset classes (e.g. US Treasuries), demand has pushed yields to levels unacceptable for many income oriented investors.

In this unprecedented environment, there remain ample opportunities in bonds. That said, lower current yields and up-trending interest rates require different strategies than those that worked in the past. Traditional fixed-income strategies such as shortening the maturity of bond holdings and remaining US focused have generated declining income over the last several years. But alternative strategies do exist.

By keeping moderate duration exposure, extending investment horizons beyond yesterday's preferred credit sectors, and expanding traditional fixed-income portfolios to include high dividend paying stocks, fixed-income investors can position portfolios more opportunistically.

## Alternative Bond Strategies

First, as interest rates rise and the yield curve begins to steepen, accepted wisdom suggests investors should shorten maturity, and thereby reduce duration (the price sensitivity of a bond—longer duration means the price fluctuates more as the yield moves up and down). By reducing maturity, the thinking goes, investors avoid large potential price shocks in their bond portfolio.

In today's bond market, with the Federal Reserve intent on keeping short-term interest rates at or near 0% for the near future, shortening maturity in isolation results in little or no income. For investors who depend upon income, yields of 0.50% or less are often times insufficient to meet expenses. However, with the yield difference between 2-year and 10-year Treasury notes currently close to 2.5%, up from 1.3% in early 2013, investors may be rewarded for laddering maturities out to 4-5 years despite the eventual risk of rising rates.

Another strategy for bond investors to consider today is broadening investments to lower rated (a.k.a. "below investment grade") credit sectors. While departing from the world of investment grade credit may be slightly uncomfortable for some, moving down the "credit curve" affords investors both potentially improved yield/total return and lower bond price sensitivity to changes in interest rates (see table below).

### Below Investment-Grade performs well versus Investment Grade in a rising rate environment

12-Month Ending:	10-Year Treasury Starting Yield	10-Year Treasury Yield Move	US Treasuries Total Return	Investment-Grade Corporates Total Return	Below Investment-Grade Corporates Total Return
Sep-87	7.42%	+220bps	-1.06%	0.20%	5.97%
Feb-89	8.15%	+117bps	3.04%	4.72%	7.32%

Dec-94	5.79%	+204bps	-3.35%	-3.34%	-1.57%
Dec-99	4.65%	+179bps	-2.38%	-1.89%	3.38%
May-04	3.37%	+130bps	-2.47%	-0.47%	13.23%
Jun-06	3.91%	+120bps	-1.56%	0.27%	4.64%

While a lower credit rating is not necessarily synonymous with lower quality, such investments typically require thorough company research but we believe that investors can be rewarded for doing their homework in today's low yield environment. By sifting through the universe of below investment grade corporate bonds, emerging market bonds, and the like, investors can find securities that perform relatively well in rising interest rate environments. Investments in below investment grade securities benefit from improving economic growth and rising inflation expectations which are two of the conditions that can trigger rising interest rates. In summary, this strategy is an effective way to better optimize the tradeoff between principal protection and income generation.

A third way that fixed-income investors can navigate a rising interest rate environment is by investing in high dividend paying stocks. Investors in high dividend paying stocks can reap the benefits of relatively stable—and possibly growing—dividend payments while potentially enjoying inflation protection and upside price potential. This is possible because investors are "owners" in the business rather than creditors and share in any inflation-generated increases in revenues and earnings.

High dividend paying stocks offer another potential benefit. Not only have high dividend paying stocks performed well in rising rate environments, generating positive returns in seven such periods since 1948, high dividend stocks have outperformed the broad stock market in five of seven rising rate environments. It is quite possible that the future may be like the past.

Surveying the factors that drive interest rates, we see that while the recent period has witnessed a steep increase in yields, higher yields also create opportunity. Moderate inflation and steadily recovering economic growth should gradually nudge Treasury yields moderately higher over the next couple of years. Obviously, yields on non-Treasury securities would also ratchet up accordingly. However, as mentioned earlier, we believe that the prospect of returning to the high single digit and even double digit yields of the 1980s and 1990s remains unlikely.

Despite three years of low interest rates, the bond market is not dead as some suggest. As yields move higher, investors can profit by resisting the temptation to rely exclusively on short-term Treasuries. Maintaining the appropriate duration exposure in bond portfolios, pursuing lower credit-rated securities and migrating into high dividend-paying stocks offer life rather than death in bonds.

**James P. Sarni, CFA**  
**Managing Principal**  
**1991 – Joined Payden & Rygel**



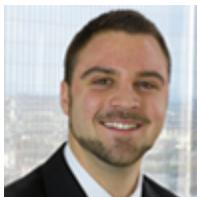
James Sarni, CFA, is a managing principal at Payden & Rygel and a member of the Executive Committee of the board of directors. Sarni is a member of the firm's Investment Policy Committee. He helps oversee the firm's US fixed-income strategies and serves as a senior portfolio manager advising pension funds, insurance companies, corporations, health care organizations, Taft-Hartley plans, universities and endowments. Sarni is a director of Payden & Rygel Global Ltd. and Payden Global Funds plc. He is also a frequent speaker with financial media and is regularly quoted on topics related to investing and the economy. He has been quoted in leading publications such as the Wall Street Journal and the Financial Times and has been interviewed on CNBC, Bloomberg TV and Fox Business Network.

Prior to joining Payden & Rygel, Sarni was a vice president and senior portfolio manager at First Interstate Bank where he managed the trust department's commingled bond funds as well as institutional client portfolios.

James Sarni is a member of the University of Southern California's (USC) Marshall School of Business board of leaders and also the board of directors of USC's Center for Investment Studies, the Pasadena City College Foundation, Descanso Gardens and Mayfield Junior School. He is also a member of the CFA Institute. He is past president of the Washington, DC-based Investment Adviser Association, CFA Society of Los Angeles and St. Philip the Apostle School board of trustees.

Sarni holds the Chartered Financial Analyst designation. He earned an MBA with an emphasis in finance and a BS from the University of Southern California.

**Peter Beer**  
**Economic Analyst at Payden & Rygel**



Peter Beer is an economic analyst at Payden & Rygel. As part of the economics group, he is responsible for researching and developing views on the US and global economy. In particular,

his research focuses on flows of funds, the global banking system, the US housing market, credit cycles, and economic history.

Prior to joining Payden & Rygel, Peter received an English Literature major at Occidental College, graduating *summa cum laude*. He wrote his senior thesis on Chaucer's dream vision, *The House of Fame*. Peter was also a Rhodes Scholar nominee in 2012.

Peter is a member of Phi Beta Kappa, a lacrosse coach in Pasadena, and a dedicated outdoorsman.

<http://merage.uci.edu/journal/ciwm/december-2013/applied-strategies.html>