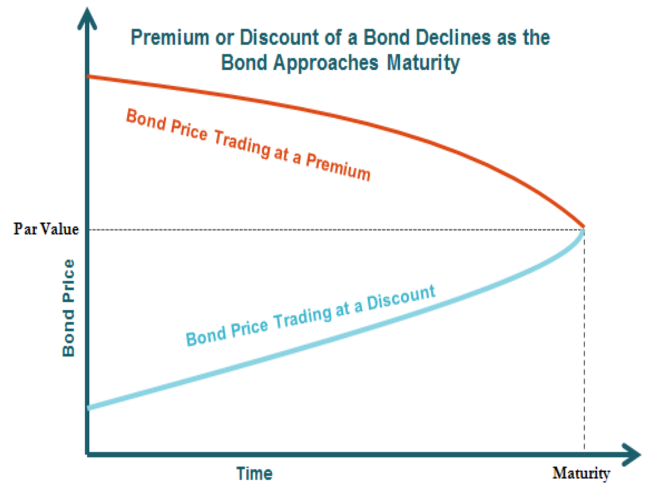
How Rising Rates Can Benefit Bond Investors

We believe bond investors who hold a well-structured and diversified portfolio have the opportunity to benefit from an increase in interest rates. For an investor in a portfolio of bonds with the intent to hold to maturity, achieving income goals is often more important than outperforming an index. Therefore the impact of rising rates may not be as detrimental to income goals as investors have been led to believe.

Bond Mechanics

As a bond approaches its maturity date, the price moves closer to the par value. This occurs regardless of the purchase price of the bond (discount, premium or par), as long as it does not default.



During the course of holding a bond, yields may move up resulting in a decline in price, or yields may move lower resulting in a price increase. However, regardless of yield movements, the price of a bond will eventually migrate to par at its maturity.

As much as we would like to avoid getting into technical bond terminology, given the benefits of duration and convexity in a rising interest rate environment, we want to spend a moment explaining each.

- **Duration:** the measure that bond investors reference to determine yield sensitivity. It provides an approximation of the change in the value of the portfolio for a given change in yields.
- **Convexity:** duration of a portfolio changes with moves in interest rates. Because of convexity, bond investors would expect interest rate increases to generally have less of a portfolio price impact than interest rate declines.

Portfolio Construction: Benefits of a Bond Ladder

Bond investors can benefit from a rise in bond yields if they hold a laddered portfolio. A laddered portfolio has a regular maturity structure such that bonds mature on regular intervals. For example a laddered portfolio has bonds that mature in 2018, 2020, 2022, and when a 2018 bond matures the proceeds are reinvested in a bond with a 2024 maturity. If yields rise during a period, then the maturing bond principal and coupon proceeds can be reinvested at those higher yields. Of course, the opposite is also possible; if yields fall you would be reinvesting at lower interest rates.

Additionally, a laddered portfolio has greater convexity than portfolios where bond maturities are concentrated together. Greater convexity results in lower portfolio market price volatility, limiting the impact that interest rate increases may have on statement value as well as the potential losses if a bond has to be sold before maturity.

Summary

We believe that bond investors who hold diversified, laddered portfolios should benefit from higher reinvestment income in the event of rising interest rates. Furthermore, the price impact of rising rates has a limited impact to investors holding bonds until maturity.