There *Are* Benefits to Rising Rates

The Advantages of Higher Interest Rates to Fixed Income Investors

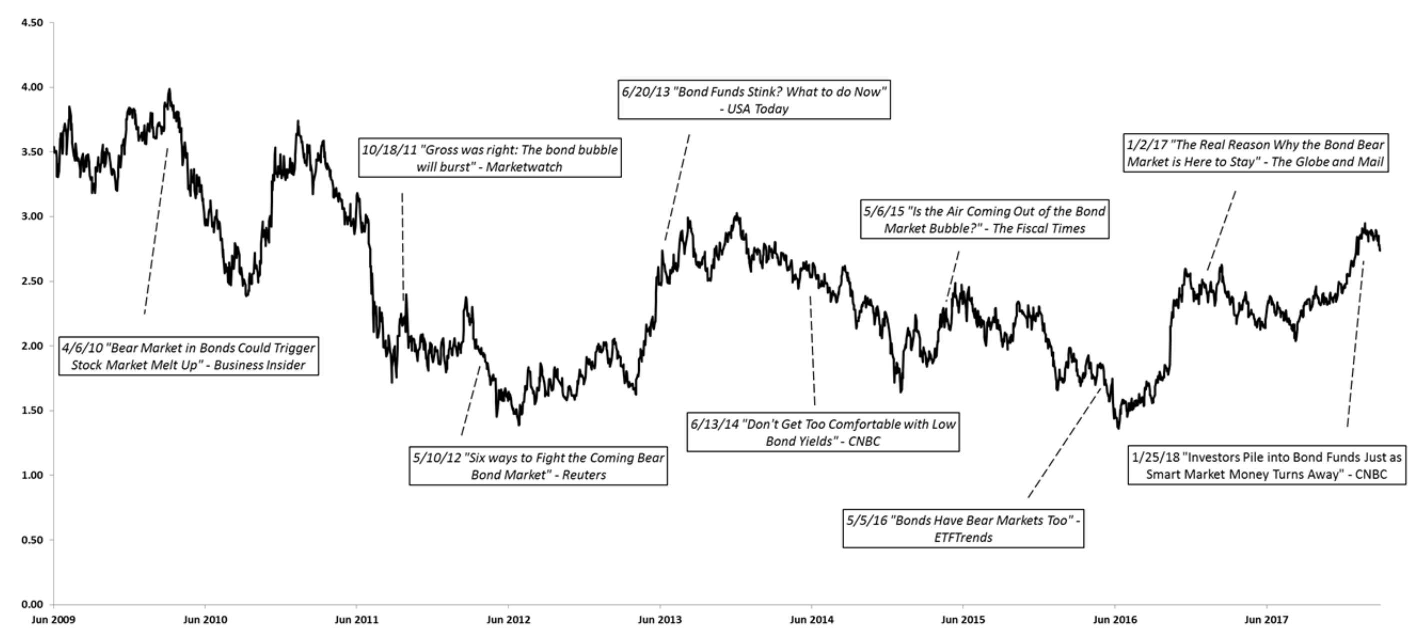
Baird Advisors

Some Perspective for the Bad News Bears

For the last several years, fixed income investors have been frustrated by the low level of interest rates. Many felt that market rates were artificially low due to the extraordinarily easy monetary policy of the Fed and other global central banks. Yet as the Fed is now normalizing monetary policy and market rates are rising, investors are being warned about the looming bear market in bonds. There is a need for some balance and perspective on this topic.

It seems that whenever interest rates begin to climb, the bad news bond bears are everywhere. Even former Fed Chair Alan Greenspan recently warned of "a bond market bubble" that will lead "obviously, toward a major increase in long-term interest rates." These bearish warnings are not new. Investors have been repeatedly warned the risk of higher interest rates for many years, yet the market has largely defied those predictions and rates have been steady to lower since the end of the financial crisis (see chart). Even as interest rates have risen in 2018, the 10-year Treasury yield has stayed well below the 3.5-4.0% range reached back in 2010-11. To be fair, rising rates do lower bond prices, but the prudent fixed income investor who stays the course rather than attempting to time the direction and extent of rate changes will ultimately reap the greatest reward in the end.

10-Year Treasury Yield (12/31/09 – 3/30/18)



Lemons or Lemonade?

Let's assume, however, that the bearish outlook is right – that interest rates are likely to move higher. The question that investors should be asking is, "Is this helpful or hurtful to my fixed income portfolio?"

Not surprisingly, most people focus on the short-term, temporary impact rising rates will have on a bond portfolio's market value. After all, an investor in fixed income assets should understand that bond prices decline as rates rise. That is simply how the math works. More specifically, the present value of a series of future cash flows (the bond price) declines as the rate at which they are discounted (the yield) rises. The magnitude of the price decline is determined by the average duration of the cash flows. A short-duration security will, therefore, decline less in value than a long-duration security for a given increase in rates.

This bond math is the lemon side of the story that is well-understood and well-reported. What is less understood and much less appreciated are the many benefits that accrue over time to fixed income investors as rates rise. To provide some balance, we would like to offer a few of these benefits, turning what is perceived as lemons into lemonade, by considering the impact on a fixed income portfolio from the perspective of three different types of investors: **the accumulator, the spender and the guarantor.**

The Accumulator

The accumulator could be anyone who is adding to their investment portfolio over time. Perhaps they are contributing to their 401(k) with each paycheck or directing a portion of an annual bonus or periodic commissions into a balanced portfolio, a slice of which is invested in fixed income assets. The regular commitment to bonds allows for more fixed income to be purchased as interest rates rise and the value of the bonds declines. The same benefits of dollar cost averaging on the equity side of the portfolio apply to the fixed income side as well. If the rise in rates occurs gradually and over an extended period, then significant fixed income assets can be accumulated at a lower average price than if rates were stable or falling. Many accumulators also gradually increase the allocation to fixed income as they get closer to retirement (think glide-path investing). If the commitment to fixed income grows as rates are rising, the accumulator benefits twice and there are many in the accumulation phase as the youngest baby boomer will be 54 years old in 2018.

Shouldn't an accumulator then prefer rising rates over stable to falling rates? We think the answer is yes.

The Spender

The spender is anyone who no longer is adding to the corpus of their investment portfolio but instead is now spending down a portion of their accumulated savings each year. The baby-boom generation is increasingly moving from accumulator to spender at the rate of approximately 10,000 per day of new retirees, and the spending trend of this demographic group will persist for many years. Higher interest rates allow the spender several favorable options. Depending on the spender's asset allocation, they could shift from short-term fixed income holdings into intermediate- and longer-term maturities, allowing them to both extend and enhance their income stream. Money can also be reallocated from equities into fixed income to help de-risk the portfolio as well as increase the average yield. And even if their allocation to fixed income remains stable, for many investors the amount of coupon income and roll-off from called or maturing bonds exceeds what they spend. This allows the (frugal) spender to benefit by then reinvesting the roll-off that is not spent at higher yields.

Should a spender then prefer rising rates over falling rates? We think the answer is yes.

The Guarantor

The guarantor is most likely an institution rather than an individual. The guarantor might be a life insurance company or a pension plan, or any entity that has an obligation to provide a series of payments in the future qualifies. Guarantors have struggled over the last several years as interest rates declined and the present value of their future liabilities rose. At the same time, the yields on securities in their investable fixed income universe declined. As higher yielding bonds in their investment portfolio rolled off, the reinvested yields fell further and further, making it increasingly difficult to meet their long-term obligations without taking on excessive risk. A life insurance company, for example, has promised lump sum payments to their policy holders, often at a guaranteed minimum value at some unknown date in the future. Higher interest rates will allow them to invest their general account assets in a way that they can more easily fulfill those obligations.

A pension plan is in a similar position as the life insurer with the one important difference being that the pension plan is typically underfunded. The pension plan, whether provided by a private corporation or a public entity such as a state or local government, has an obligation to provide a lifetime income stream to their members upon retirement. Unfortunately, the average public pension plan is only about 70% funded in relation to the value of their liabilities. Corporate pension plans are in better shape with an estimated 88% funding status. One factor contributing to the underfunded status of pensions has been the rising present value of their liabilities as market rates declined. The present value of plan liabilities is typically longer in duration and more sensitive to interest rate movements than the shorter-duration plan assets. Since most pension plans have more liabilities on a present value basis than assets, rising rates would help improve the math regarding the average plan's funding status. Also, the median assumed discount rate on public pension plans remains a relatively high 7.5%, which may be difficult to achieve if the 10-year Treasury yield remains near 3% for an extended period. The ability to earn a higher rate of return on the core fixed income assets in a pension plan, along with a reduction in the present value of the future liabilities, would help reduce the unfunded liabilities of pensions all across the nation. Higher rates would also help ease the burden of rising annual pension contribution levels by companies and governmental entities.

Should a guarantor then prefer rising rates over falling rates? We think the answer is yes.

Managing Duration Risk

Perhaps the bears will be right this time. While we don't think it's as "obvious" as Mr. Greenspan suggests, we acknowledge that there are strong cyclical forces applying upward pressure on rates currently. Fiscal stimulus from the tax cuts and rising federal spending, as well as a reduced regulatory burden are, together, powerful forces against the long-term, disinflationary trends that have helped to hold rates low for an extended period. These secular forces, including an aging population, the ability to substitute technology for labor, and elevated government debt and unfunded liabilities remain and will likely limit the extent to which rates rise over the next several years.

At Baird Advisors, we pay very close attention to the level and direction of interest rates, to economic data, and to changes in monetary and fiscal policy. This analysis influences our bottom-up decisions such as sector weightings, security selection and yield curve positioning – areas where we feel we have the best opportunity to add value on a consistent basis. However, we believe trying to time changes in interest rates by adjusting portfolio duration is a loser's game. As a fixed income manager focused on controlling portfolio risks, all of the more than $60 billion of fixed income assets we oversee are managed on a duration-neutral basis relative to their respective benchmarks. We believe the appropriate level of interest rate risk for an investor is best determined as part of the overall asset allocation decision. In that discussion, the average duration of the invested assets should approximate, as closely as possible, the average duration of the investor's time horizon of expected liabilities.

Conclusion

Understandably, the cyclical strength in the economy is helping to fuel the bearish sentiment in the bond market. While these forecasts are nothing new, the fact that the cyclical pressures are occurring while the economy is at full employment suggests that the upward trend in rates may continue. Yet secular disinflationary forces have not gone away and will likely limit the extent to which rates rise. Even if the prediction of higher rates proves to be correct, investors in fixed income assets should understand that this will be beneficial to their portfolio over time. Over an extended period, more than 90% of the total return on a fixed income portfolio comes from income, so a rising level of income will enhance returns over time. Individuals at all ages and life-cycle stages, whether in the accumulation phase or spending phase, can benefit as rates trend higher. For institutional investors that have an obligation to provide a series of payments in the future, higher rates will help them to do so without taking on excessive risk in their investment portfolio. The negative side of the story of higher rates is well-understood, but the benefits over time that come with rising rates will ultimately outweigh the near-term concerns.

Disclosures

This is not a complete analysis of every material fact regarding any company, industry or security. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks such as interest rate risk, credit risk, inflation risk and liquidity risk. In a rising interest rate environment, the value of fixed income securities generally declines and conversely, in a falling interest rate environment, the value of fixed income securities generally increases. High-yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield.

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