BEACON POINTE ADVISORS

BEACON POINTE RESEARCH
WHITE PAPER

FIXED INCOME – IMPLICATIONS OF INTEREST RATES HIKES
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Fixed Income – Interest Rate Hikes

Fixed income and its potential performance, especially in light of rising interest rates, should be considered in the context of their role in an investor's overall portfolio. Fixed income provides stable income generation, portfolio diversification, a deflationary hedge and an instrument to match liability streams. Their role as a deflationary hedge can come in useful during times of "shocks" to our financial or political systems.

In recent times, our clients have expressed concerns regarding the impact of rising interest rates coming off 45-year lows. Investors are in a quandary as to what needs to be done with their fixed income portfolio. Most investors appear to be nervous about the impact on their capital as bonds depreciate in value when interest rates go up. But, depending on the time frame, rising interest rates can have surprising benefits that most investors may not initially recognize.

Studies have shown that approximately 90% of the total return generated by bonds come from the income generated by these bonds over time. Only 10% of the return is attributable to the capital gain or loss – the change in the value of the bond since the time of purchase. Beacon Pointe published a white paper addressing the impact of rising rates on fixed income portfolios (April 2004).

Below is an updated version of the scenario analysis performed by PIMCO as shown in our internal memo released (April 2004). The analysis reveals the hypothetical illustration of annualized index returns (in percentages) over various time horizons. The scenario analysis assumes that the rates would increase on a single day and are held constant for the remaining periods.

Exhibit 1

Change in Interest Rates	1-Year	3-Year	5-Year	7-Year	10-Year
+ 200 bps	-1.9	4.2	5.2	5.6	6.0
+100 bps	1.9	4.7	5.1	5.3	5.4
0 bps	5.6	5.3	5.1	5.0	4.9
-100 bps	9.4	5.9	5.0	4.7	4.4

Source: PIMCO

As seen from the table, the five-year returns are quite similar despite varying interest rate scenarios. This is due to the fact that the capital losses/gains are offset by the reinvestment of income and proceeds at higher yields. In fact, to the surprise of many, reinvestment and compounding in a rising rate environment may actually result in higher returns for long-term investors. If the Fed were to raise interest rates by 200 bps, only the one-year time horizon results in a negative return. Investors need to understand that the resulting -1.9% decline in total return is fairly insignificant compared to the negative performance of portfolio should the equity markets face difficult environments as were seen in 2000 through 2002.

Fixed Income – Interest Rate Hikes and Declines Over a Cycle

Investors might ponder the outcome of their fixed income portfolio over a full interest rate cycle – let us assume interest rate increases for two years, steady state for a year, and then interest rate declines for the next two years.

Bernstein Research[1] performed one such study in April 2003. The assumption made in their study includes active management of the fixed income portfolio to maintain duration[2]. However, in contrast to PIMCO's analysis, they assumed that all income is withdrawn and spent. In other words, the portfolio returns are not enhanced by the reinvestment of interest incomes in a rising interest rate environment nor is it impacted by the reinvestment of investments in a declining interest rate environment. This approach was used, as it is a more conservative method to evaluate the impact of a changing interest rate environment.

As noted earlier, as interest rates rise, the market values of bond prices fall and the total return is offset by increased income generated by the bonds. Conversely, as interest rates decline, the market value of the bonds rise and is offset by declining income. To add another dimension, the longer the maturity of the bonds, the more the rise or fall in the market value and the income generated, depending on the direction of change in the interest rates.

The Bernstein study indicated that when interest rates rise, income increases, so long as the portfolio is actively managed to maintain its duration over time. Active management enables the purchase of new, higher interest bonds for the portfolio in order to earn more income. According to their study, for a one percentage point rise in interest rates over two years, the incremental income for the short and intermediate bonds was in the range of $27,000 to $37,000 for a $1MM bond portfolio. However, for the long bond, the incremental income was only $6,000. This is due to the larger fall in these bond prices restricting purchase to fewer new higher-income producing bonds to replace the old ones. However, the long bonds did still generate the highest total income – a function of higher yield resulting from taking extra risk.

In the falling rate scenario, it is assumed that interest rates fall back to their initial levels over the next two years. Based on the analysis of the full cycle of interest rate change, Bernstein concluded that all of the portfolios, except for the long bond portfolio, produced far more income in total than if interest rates had been stable. In the case of the long bond portfolio, the total income generated was just marginally higher than if interest rates were stable.

However, with regards to market value, if there is a need to cash out during the interest rate hikes, then investors lock in the decline in the lower market value. Thus, it is important to keep one's time horizon in mind when investing in fixed income securities. As long there is no need for cash outlays from your fixed income portfolio, one is better off holding on to their fixed income in a rising interest rate environment to benefit from higher income from an actively managed portfolio. However, from a risk/reward tradeoff, investors are better off in the short/intermediate maturities, especially in light of

[1] For more information, please visit http://www.bernstein.com/Public/story.aspx?cid=472.
[2] Duration is a measure of sensitivity of a portfolio to interest rate movements.

relatively near-term time horizons. This result is due to a smaller decline in the market value of these bonds when interest rates rise. However, over a longer timeframe, bondholders pick up more yield, the longer their portfolio's maturity, despite more volatility in the short-term.

Fixed Income – Conclusion

- Beacon Pointe Research believes investors should stay with their strategic allocation to stocks and bonds, despite facing a rising rate environment. We believe the impact on the market value will be offset by rising income to boost total return over the long-term.

- Please contact your Beacon Pointe consultant should you have any questions.

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