The Financial Navigator – September Newsletter

With the Federal Reserve's decision last week to continue its program call 'Quantitative Easing', or commonly known as QE3, the market gyrations we experienced this past summer may be prodded to reappear again after a few months of market calm. The program was originally designed to stimulate the economy by keeping interest rates low, and it has also served to prop up the US stock market. Now the market pundits are pondering when the Fed may wind down this stimulus program, and what market timing moves to make as a result. The article below addresses whether the eventual shut down of QE3 should be something for you to worry about and how accurate these pundits have been in the past. In addition we also include an article on the role of fixed income investments (bonds & cash) in your portfolio. This may be an important consideration as in today's low yield market investors have been searching for higher yields and taking on higher risk to achieve this goal. Reading the article may help you determine whether this higher yield-higher risk quest is appropriate for you.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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Second Guessing

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Markets over the summer have had a rocky time as investors in aggregate reassess prospects for monetary policy stimulus in the US. Based on this week's decision by the Fed to leave interest rate alone and to continue its bond buying program geared to keep rates low until the economy recovers, one might ask the question - Is this something to worry about?

In May the world's most closely watched central bank unsettled financial markets by flagging that it may start to scale back its bond purchases later this year. What spooked the markets was a comment by Fed Chairman Ben Bernanke on May 22 that the central bank may start to scale back those purchases in coming meetings. The mere prospect of the monetary tap being turned down caused a reassessment of risk, leading to a retreat in developed and emerging economy equity markets, a broad-based rise in bond yields, and a decline in some commodity markets and related currencies, such as the Australian dollar.

Gold, in particular, was hit hard by the Fed's signals, with the spot bullion price falling 23% during the second quarter on the view that rising bond yields and a strengthening US dollar would hurt the metal's appeal as a perceived safe haven. For the long-term investor, there are a few ways of looking at these developments.

First, we are seeing a classic example of how markets efficiently price in new information. Prior to Bernanke's remarks, markets might have been positioned to expect a different message than he delivered. They adjusted accordingly.

Second, since the patient is showing signs of recovery, policymakers can publicly countenance a change in policy—"taking away the punch bowl." This is not to make any prediction about the course of the US or global economy. It just tells you that policymakers and investors are reassessing the situation. Third, for all the people quitting positions in risky assets like stocks or corporate bonds, there are others who see long-term value in those assets at lower prices.

Fourth, the rise in bond yields is a signal that the market in aggregate thinks interest rates will soon begin to rise. That is what the market has already priced in. What happens next, we don't know. Keep in mind that when the Federal Reserve began its second round of quantitative easing in late 2010, there were dire warnings in an open letter to the central bank from a group of 23 economists about "currency debasement and inflation."[1] Yet, US inflation is now broadly where it was, and the US dollar is higher than when those warnings were, suggesting that basing an investment strategy around supposedly expert forecasts is not always a good idea.

So, it would pay to exercise skepticism with respect to predictions on the likely path of bond yields, interest rates, and currencies in the wake of the Fed's latest signals this week. Just because something sounds logical doesn't mean it's going to happen.

Fifth, a rise in bond yields equates to a fall in bond prices. Just as in equities, a fall in prices equates to a higher expected return. So selling bonds after prices have fallen echoes the habit some stock market investors have of buying high and selling low. Finally, keep in mind the volatility is usually most unnerving to those who pay the most attention to the daily noise. Those who take a longer-term, distanced perspective can see these events as just part of the process of markets doing their work.

After all, the individual investor is unlikely to have any particular insights on the course of global monetary policy, bond yields, or emerging markets that have not already been considered by the market in aggregate and built into prices. What individuals can do, with the assistance of a professional advisor, is manage their emotions and remain focused on their long-term, agreed-upon goals. Otherwise, you risk reacting to something that others have already countenanced, priced into expectations, and moved on from as further information emerged. Inevitably, second-guessing markets means second-guessing yourself.

Balancing Your Fixed Income Decisions

Fixed income can play an important role in a portfolio. But its role may vary according to an investor's financial needs and concerns. For example, many investors look to fixed income for safety, income, and more stability in their portfolios. They must weigh these priorities against their concerns over future interest rates, inflation, government debt, and other factors that might affect fixed income returns.

Striking this balance can be a challenge in any market environment, but especially now, as low interest rates have sent many investors on a quest for higher-yield bonds or alternative investments. Depending on your approach, this pursuit of yield may invite more risk—some of which may be hard to see or understand.[1]

So, what's an investor to do? How can you make prudent fixed income decisions while also addressing today's low interest rates? Consider these principles:

Remember How Markets Work

The same core investment principles apply in any market environment. One key principle is that in a well-functioning capital market, securities prices reflect all available information. Today's bond values reflect everything the market knows about current economic conditions, growth expectations, inflation, Fed monetary policy, and the like. So, according to this principle, the possibility of rising interest rates is already factored into fixed income prices.

This is one reason investors should view future interest rate movements as unpredictable. Even the market experts who have access to vast amounts of research have a hard time predicting the direction of interest rates. For instance, despite regular predictions of rising interest rates over the past two years, nominal yields on US Treasuries and longer-term bonds have continued falling and now are at historic lows.

Rather than trying to predict macroeconomic forces that are difficult to foresee, investors can look to the market to set prices and focus on the variables within their control.

Start with a Clearly Defined Goal

Fixed income choices should follow a broader investment strategy that defines the role of fixed income in a portfolio. The portfolio can then be customized to meet those specific goals while managing tradeoffs.

The chart below illustrates how portfolio objectives can influence a fixed income approach. An investor who wants to seek to avoid losing market value might have a different fixed income allocation from someone who wants to take a balanced approach, needs immediate income, or is seeking higher returns. Investors with different objectives typically have different tradeoffs regarding risk, expected return, and costs.

Investment Objective Helps Determine
Fixed Income's Role in a Portfolio

OBJECTIVE	ROLE OF FIXED INCOME
Avoid losing money	Capital preservation
Keep portfolio in balance	Volatility customization
Meet income needs	Liability management
Seek higher returns	Total return

For illustration purposes only

Know What You Own

Strive for transparency in a portfolio. This means understanding an investment manager's basic strategy and knowing how the instruments held in the portfolio might respond in different economic, market, and interest rate scenarios.

Unfortunately, investors who chase performance often make their investment decisions based on the past performance and perceived popularity of the strategy. For example, some of the mutual fund categories experiencing the heaviest inflows of cash in the industry are in asset groups that have recently experienced higher than average yields. Higher yields are typically accompanied by higher risks. But do investors know what risks their managers are taking to deliver those attractive yields?

Understand the Tradeoffs

When reaching for higher yield, investors should carefully consider the potential effects of their decisions on expected portfolio performance and risk. In the fixed income arena, investors have two primary ways to increase expected yield and returns on bonds. They can:

- Extend the overall maturity of their bond portfolio (take more term risk).
- Hold bonds of lower credit quality (take more credit risk).

These may be reasonable actions. But pursuing higher income means accepting more risk, as measured by interest rate movements, price volatility, or greater odds of losing value if the issuer defaults.

Pay Attention to Costs

Investors typically do not realize that investment-related costs determine a large part of a portfolio's yield and return. This applies especially to fixed income securities. In fact, research has shown that a bond mutual fund's expense ratio helps explain much of its net performance—and funds with the highest expenses tended to have the lowest performance within their peer group.[3]

Consider a Global Fixed Income Strategy

Investors have other tools to enhance risk and expected returns in fixed income. You can expand your opportunity set by moving beyond your domestic fixed income market to access yield curves in other country markets. By owning bonds issued by governments and companies from around the world, investors can enhance diversification in their fixed income portfolios. After hedging against currency risk, bond markets around the world have only modest correlations. (Correlation refers to how similarly two investments perform in the same period.) As a result, a global hedged portfolio should exhibit lower volatility than a single-country portfolio or a global portfolio that does not hedge currency risk, and offer the opportunity to take advantage of more attractive yield curves abroad.

Summary

No one really knows when and by how much interest rates will change. Many market pundits have forecasted an upward move for several years now. Investors looking for higher bond yields should understand the higher risks tied to their decisions. Most investors might be best-served by building a fixed income strategy to complement their broader portfolio objectives, understanding the sources of risk and expected return, paying attention to fees, and looking beyond their own country to capture yields in other countries' markets.

References

1. Floyd Norris, "Predictions on Fed Strategy that Did Not Come to Pass," New York Times (June 28, 2013).

2. When interest rates rise, the value of an existing bond declines; when rates fall, existing bond values rise. The market adjusts a bond's price to match the yield available on a new instrument. Investors who hold fixed income securities with longer maturities are exposed to the amplified effects of term risk. A long-term bond is more exposed to rate changes than a short-term instrument, and usually (but not always) offers a higher yield to compensate investors for the extra risk. Also, lower-coupon bonds are more affected by interest rate changes than higher-coupon bonds. For example, if rates move 1%, a bond that pays 3% will experience a greater gain or loss than one paying 5%.

3. The study examined monthly alpha and expense ratios for bond funds in the CRSP survivorship-bias-free mutual fund database from January 1992 to December 2011. Source: Dimensional Fund Advisors.