CAPRIN
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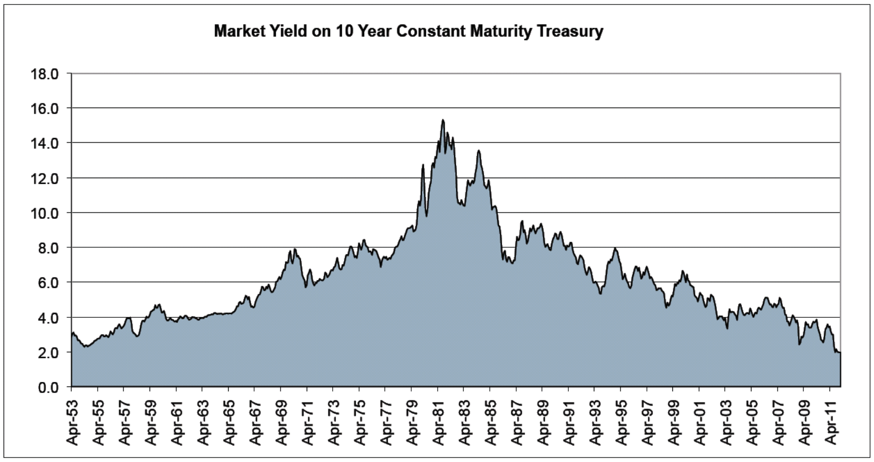
PREPARING FOR NEW REALITIES IN FIXED INCOME
A CONVERSATION WITH
MICHAEL HOOVER, CFA, PRESIDENT

Q: Bond investing has consistently been great for me. Everything I bought has paid off. Why should I not just stay the course?

A: So much of this comes down to psychology that it really depends on your perspective. People have gotten used to steady interest income accompanied by steady capital appreciation, so they look at their bond portfolio like a pool of CDs. But how will they react when their statement values decline when rates rise? We've gotten phone calls from million-plus-dollar portfolio clients worried that their bonds were down $4,000 in a month. 'What,' they ask, 'went wrong?' We worry the lack of understanding about declining bond values will beget a more desperate question: 'Will I run out of money?' Investors felt that in stocks when the tech bubble burst, and they felt it more recently in housing. This is their safe money. At some point, bond investors will have to come to terms with the fact that the value of their bond portfolio is down.

Q: But for 30 years now, that's not been the case. Are you suggesting there is a great deal of complacency in the marketplace ?

A: Correct. Interest rates have fallen so much, and they're now so low, that total return has been far greater than anyone expected. But turn that graph upside down and it's a picture of pain. In 1994, while I was at T. Rowe Price, interest rates shot up 2.50 percent over 12 months, and bond prices got hit across the board. We fielded calls from customers who confessed they didn't know they could see negative returns in a short-term bond portfolio. They didn't appreciate the magnitude of bond math: prices decline when yields rise.



Source: US Federal Reserve, data as of 3/2012

Q: Yes, but now the Federal Reserve is on my side, having bought trillions in bonds to keep rates down. Why fight the Fed?

A: Even the Fed chairman himself admitted he is using tools that are not fully tested -- and there's disagreement within the Fed. Particularly after the announcement of QE3, you're seeing more market watchers wonder how sustainable this strategy can be, and if/when too much money in the system will spark inflation. With such unprecedented action, we just don't know what our creditors might demand if risks become too great or confidence in our fiscal discipline becomes too low.

Q: You've spoken of how today's fixed income risk tolerance lacks a generational and institutional memory of a high interest rate environment.

A: Think about how different the world was the last time there was a true bear market in bonds. Very few people actually had fixed income assets, and bond mutual funds were a novelty. Back then, in the late 1970s and early

1980s, if you owned bonds you clipped coupons and sent them in for a check. Most savers had bank CDs. And you actually had to go to the bank to see the rates change on the sign. There was nothing like today's 24/7 online access to portfolio values and of broader net worth. That all vastly changed in the 1990s. Many asset classes have experienced boom and bust in the very real-time Information Age, marked by nonstop cable TV and Internet coverage. And so we find the prevailing belief that, 'I cannot lose money in bonds' because that's what history has shown. Even when investors buy bonds to earn 1.50% over ten years, they think only about the lower rate of interest they'll receive, and not appreciate the emotional consequences of their 'safe money' possibly falling 7% in value. The successful financial advisor will want to help his clients avoid the angst that will come from an extended bear market in bonds. Just think about the $900 billion that has gone into bond funds in just four years. How much of that will stampede for the exits – at any price, ASAP -- when emotions take over? Our bias is not to wait until after the train wreck to clean up the mess. We'd prefer to address risk and reposition portfolios *before* the bear market arrives.

Don't be this guy

Q: What do I do then?

A: To be sure, there are those clients who want to generate as much income as they can over the short term; they are not worried about portfolio value. But we think there's a great opportunity to avoid anxiety and harvest superior capital gains in long and medium-term bond portfolios. Reduce that portfolio average maturity, and think of the lower income as an insurance policy on all that capital appreciation you bank. Think of the reposition as a safety net. That's the role of this money in the first place. Ask yourself if your client is comfortable being down 7% to 10% in their bond portfolio over 12 months if interest rates pop like they did in 1994 and 1995. Think tech stocks and real estate, and how investors got caught up in those crowded trades. As fixed income investors, we are naturally risk averse, and constantly ask ourselves what could go wrong. Could interest rates run away from us? What about volatility? Witness how a single *60 Minutes* interview of one financial pundit convulsed the $4 trillion municipal bond market. That was a prime example of how quickly markets can move, and how critical it is for financial professionals to have strategies at the ready to respond.

Q: So then what are you doing to prepare?

A: We've developed managed strategies with daily risk measuring, to be as liquid, nimble and flexible as possible. Each of our strategies is borne from our philosophy of capital preservation and income (hence our name *Ca-pr-in*). Believing in the importance of risk management, particularly as risks evolve through the interest rate cycles, we help advisors pair clients with those solutions most appropriate for their risk tolerances.

The biggest vulnerability for financial advisors is exposure to fixed income products that have not been adequately stress-tested for client comfort zones. Volatile markets have a knack for rapidly changing those tolerances. As markets push interest rates to all time lows, the need to discuss risk solutions for an interest rate cycle not experienced in 30 years is more important than ever.

Be *pro-active.* Get ahead of the curve – literally. Once the phone starts to ring, it'll be too late.

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