CAPRIN
Asset Management, L.L.C
Capital Preservation & Income

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Strategy Considerations for Bond Investors

Introduction

Caprin's Capital Preservation and Income culture drives the investment philosophy and processes for client portfolios. Our emphasis on higher quality, stronger liquidity, and lower risk has served our clients well, particularly during the unprecedented market volatility of 2008-2009. This tumultuous time witnessed many once-in-a-generation developments, including historically low interest rates. Because all fixed income strategies are subject to the market forces of interest rate changes, we thought it appropriate to provide an overview of these concepts and our investment solutions.

Why Bond Market Values Fall when Interest Rates Rise

Bonds are fundamentally mathematical investments: the interest rate and number of coupon payments are fixed, the maturity date is fixed, and the amount paid at maturity is fixed. The primary variable that impacts the market value of a bond is market interest rates.

Consider the following example (*Figure 1*): The market dictates that a bond with a 3 year maturity warrants an annual yield (return) of 3% and Investor A purchases a newly issued 3 year bond with an annual coupon of 3% (3% x $100,000 par value =$3,000/year). By paying $100,000 for the bond, collecting $3,000 per year in interest, and collecting $100,000 at maturity, Investor A has locked in that 3% return. If market interest rates increase, and bonds with 3 year maturities must now provide a 4% yield, how can Investor B buy Investor A's bond and earn 4%? Since the coupon at $3,000 per year and the $100,000 paid at maturity are fixed, investor B can only achieve that 4% return by paying less for the bond today, $97,225 in this case.

	Required Return	Payment 1	Payment 2	Payment 3	Received at Maturity	Market Value That Achieves Required Return
Investor A	3%	$ 3,000	$ 3,000	$ 3,000	$ 100,000	$ 100,000
			Market Rates Rise, Price Falls			
Investor B	4%	$ 3,000	$ 3,000	$ 3,000	$ 100,000	$ 97,225

Figure 1.

Time to maturity is the most important factor influencing a bond's price reaction to any change in market interest rates. The longer Investor A locks in the yield on his bond, the longer before the bond's maturity can be reinvested, and thus the greater the impact on today's market value. A bond with a shorter maturity will be less affected because the maturity proceeds will be available sooner to reinvest at potentially higher yields. In fixed income investing, the measure of a bond's exposure to interest rate fluctuations is "duration" – loosely defined as the weighted average time to maturity of a bond's cash flows (interest payments and principal at maturity). The greater a bond's or a portfolio's duration, the greater the potential change in market value for a given change in interest rates.

It is important to emphasize that a bond that matures will have earned an annual return over the holding period equal to the yield locked in at purchase. And, monthly statements that show swings in market value either up or down simply indicate the approximate value <u>if</u> the bonds were sold at that time.

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Interest Rate Risk

Just like an equity allocation, where an investor can choose large, mid, or small cap stocks, growth or value stocks, etc, each of which have their own risk/reward potential, similar opportunities exist for bond investors, and their appropriateness depends upon one's goals and tolerances. Under most normal interest rate conditions, the following generally apply

- The greater the portfolio duration, the greater the yield earned <u>and</u> the greater the potential change in market value for any given market interest rate change. In other words, higher duration portfolios should exhibit greater unrealized gains as rates fall, and larger unrealized loses as rates rise.
- Portfolios with shorter durations usually will earn lower yields and should generally show smaller levels of unrealized gains or losses

We at Caprin historically have viewed an intermediate duration portfolio as the appropriate vehicle for the core of an investor's bond allocation. It is expected to deliver a balance of yield and interest rate risk. That said, however, investment markets generally have produced a 27-year environment of steadily declining interest rates. *Figure 2* shows how interest rates have trended lower over the last 18 years. Despite the longer-term trend, though, there have been brief periods of sharply rising rates, during which bond portfolios experienced a drop in statement value. In our opinion, this long term trend has painted an incomplete picture about fixed income market values relative to the range of market interest rates.

While we are not able to predict interest rates, we recommend that clients and their financial advisors regularly review income goals and market value tolerances as part of the overall planning process.

Figure 2. 10-Year AAA Muni Yields since March 1991 *Source: Bloomberg*

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The Market Value – Yield Trade Off

Bond investors who find themselves uncomfortable with lower market values driven by rising interest rates and who are willing to accept potentially lower yields as a trade-off to market price volatility might consider a shorter duration bond strategy. *Figure 3* below illustrates the yield reduction associated with moving to a shorter duration bond strategy in late August 2010. Market interest rates are constantly evolving, and we encourage investors to consult with their financial advisors about current conditions.

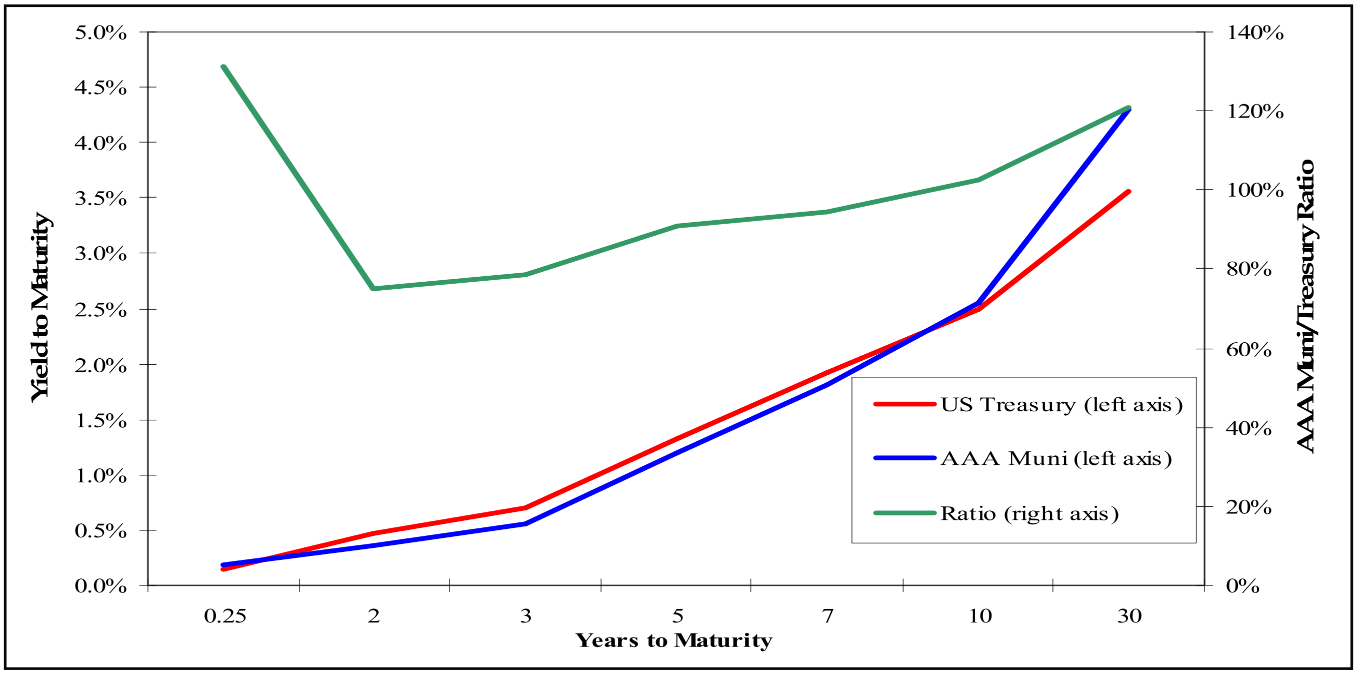

Figure 3. Yield Curves as of August 24, 2010 *Source: Bloomberg*

Conclusion

We have stressed in this paper the fundamental exercise of assessing the desired amount of yield (income) and the tolerances for market value fluctuation. Over time, we believe Caprin's intermediate duration strategy strikes a reasonable balance between these goals.

However, we also recognize client risk tolerances change, and we remain committed to providing a menu of bond strategies to meet various goals. Therefore, we are pleased to offer a Low Duration Municipal Bond investment strategy for investors seeking to reduce or diversify market value risk in a rising interest rate environment. The Low Duration Strategy incorporates the same quality and liquidity characteristics as our Intermediate Duration Strategy but with less interest rate risk. As with any investment strategy, each client should consult with his or her financial advisor to explore the risks of investing in this or any other fixed income strategy and the appropriateness for his or her respective financial situation.