HIGHLIGHTS

- Too many investors believe that bonds can only go up in value
- Caprin's bias is to not wait until after the wreck to clean up
- Time to take a fresh look at the potential risks in your bond portfolio

The Forgotten Lesson of 1994?

"Cast your minds back to 1994. The Federal Reserve had kept rates at (what seemed then) the low level of 3% for three years in an effort to allow the financial sector industry to recover from the savings & loan crisis, a problem that was the result of reckless expansion and lending (thank goodness they learned the lessons of that disaster). The Fed then started very modestly to tighten monetary policy with a quarter point rate increase. ***But the bond market had its worst year since the late 1920s****."*
- The Economist

Eighteen years later, a golden age for fixed income has lulled too many investors into the false belief that bonds can only go up in value. Caprin president Michael Hoover recalls how in 1994, when he was at T. Rowe Price, interest rates shot up 2.50 percentage points over 12 months, hitting the entire spectrum of bond prices. "We fielded calls from customers who confessed they didn't know they could see negative returns in a short-term bond portfolio," he recalls.

Today, according to the Leuthold Group, a Treasury bond that matures in 2031 that yields 2.35% would experience a 12% total-return loss in two years if interest rates shot up to 4%. That loss would hit 15% if rates went to 4% in 12 months.

But how would a 1994-like rate scenario play out now? We calculate that a 2.50 percentage point jump in rates over 12 months would cause a total-return loss of 7 percent on a model intermediate-maturity bond portfolio. "Today," says Hoover, "investors buying bonds to earn about 1.70% over ten years tend to think only about the lower rate of interest they'll receive, and not the emotional consequences of their supposedly 'safe' money possibly falling 7% in value."

At Caprin, our bias is to not wait until after the wreck to clean up the mess. We'd much rather address risk and reposition portfolios now, to help you and your clients avoid the pain and angst that will come from a bear market in bonds.

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