Caprin Asset Management

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Time Is On Your Side

Investors are looking forward to a healthier economy that brings with it higher interest rates and the prospect of much improved income from their bond portfolios. Too often though, investors are distracted by the oft-quoted "bond prices fall when interest rates rise" which ignores how time is a powerful contributor to making higher rates work in your favor.

Where are interest rates headed? Short-term rates remain anchored by exceptionally accommodative monetary policy from the Federal Reserve, while the intermediate to longer portions of the curve have seen intermittently higher levels driven by expectations for additional stimulus, renewed economic growth, and possibly higher inflation. This environment is typical of a transition period as policy adjustments seek a balance that will support a more normalized economy. Naturally, the Federal Reserve has suggested a tendency toward slightly higher short-term rates as that materializes. Fortunately, we do not believe we are heading into a longer-term inflationary environment.

So why are rising interest rates a good thing? It is important to highlight that interest rates typically rise gradually over time and not in a dramatic or instantaneous way. As rates rise, your bond portfolio has maturities and coupon payments to reinvest into higher bond yields, thus allowing the income component of the portfolio to also gradually increase and help offset price declines that other bonds may experience. In addition, as time moves forward, the bonds remaining in the portfolio 'roll down the curve,' meaning their time to maturity becomes shorter, which reduces their sensitivity to rising rates.

The power of dollar cost averaging new bond investments into a higher rate environment is the most valuable of all techniques to combat rising rates. Portfolio maturities, selective swaps, and deposits are also effective ways to gradually own a greater percentage of the portfolio in higher yielding bonds. Over time, the entire portfolio will become invested in bonds purchased in the higher rate environment, and the bond allocation will be fully invested at far better yield and income levels. All too often investors try to time the peaks and troughs of interest rate cycles, but our experience suggests that this all or nothing approach is not advantageous. Caprin's strategic approach for positioning duration and maturity structures helps combat rising interest rates with the aforementioned techniques while seeking a desirable portfolio profile for attractive returns and beneficial income.

To help illustrate the importance of our portfolio construction and the power of reinvesting as rates rise, we conducted a portfolio simulation using a 4.50 year duration municipal bond portfolio. We assumed interest rates would increase 25bp every six months over a 2 year period, and the graph below shows the interest rates used and the impact of that scenario on portfolio value.

Founded in 1997, Caprin is an asset management firm that applies the substantial experience and expertise of its professionals to the creation and management of forward-looking investment solutions for those seeking wealth preservation and income generation

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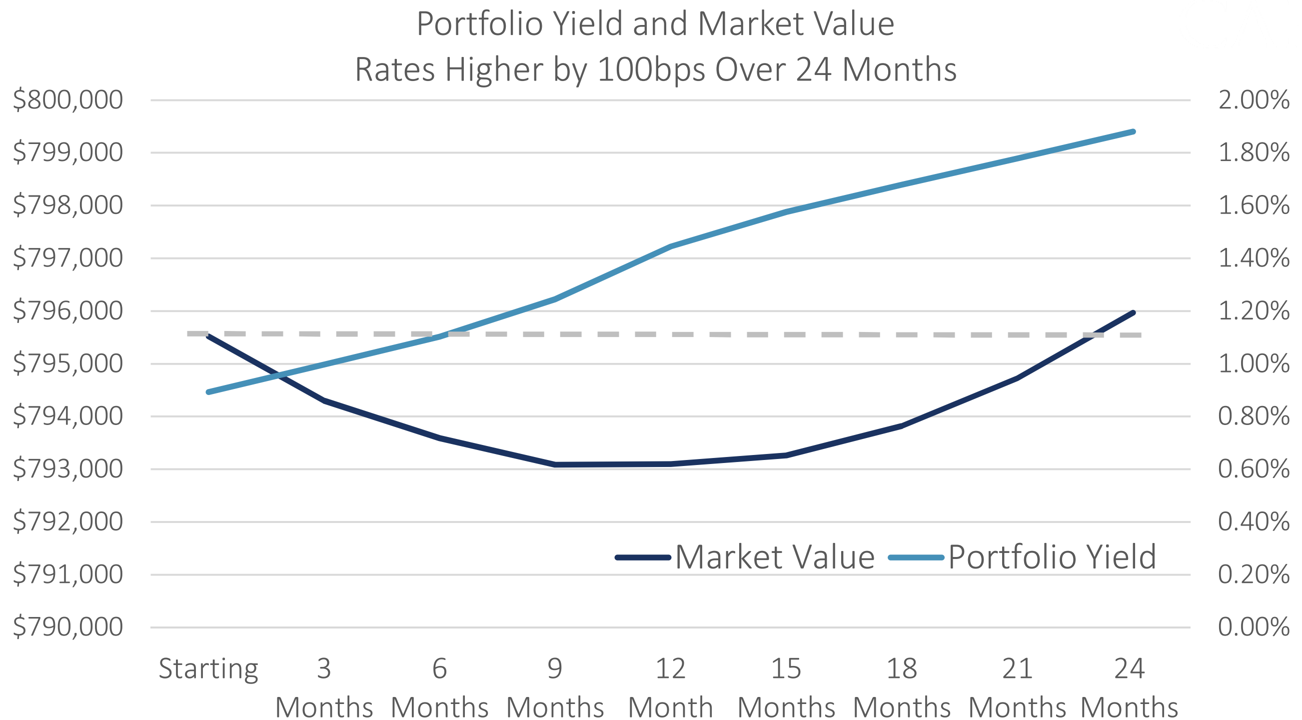

Many investors become concerned when they believe interest rates may increase, fearing that a 100bp (1 percentage point) rise will cause portfolio value to fall by 4-5%. That is a true statement if your time horizon is one day! But time does not stand still, and this simple statement is often overlooked when analyzing bond portfolio returns.

A quick look at the graph shows how Time is On Your Side. As the portfolio acquires increasing amounts of higher yielding bonds, portfolio value stabilizes and then begins to rise as portfolio income levels increase. As more and more of the portfolio is invested in higher yields, the additional income compounds and contributes to positive portfolio returns even as interest rates continue to rise.

In conclusion. Bonds continue to fulfill their mission of lowering overall investment risk while providing a steady source of income even though interest rates are low and may rise in the future. Investors need not be concerned about higher rates because time is your bond portfolio's true ally when it comes to improving portfolio income. For investors thinking about reallocating assets and reducing risk in their portfolios, we view the current yield environment as a still very reasonable entry point. While interest rates have risen somewhat in '21 and may move moderately higher as near-term growth and inflation find equilibriums, we do not expect protracted or significant pressures on intermediate and longer-term yields. We hope this illustration shows the value of 'Time Is On Your Side' when managing bond portfolios as interest rates rise, allowing your bond allocations to remain a steady source of investment income.

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