October 19, 2015

THE THREAT OF RISING INTEREST RATES IS NOT THE GREATEST RISK

IT'S WELL KNOWN THE FEDERAL RESERVE PLANS TO RAISE INTEREST RATES

For months, the Federal Reserve Open Market Committee (FOMC) has made it explicitly clear that it plans to begin raising interest rates sometime this year. For at least a year, the question of *when will the FOMC pull the trigger* and begin returning interest rates back to a more normal level has been a major focal point of the financial press and the investment community. There is no question of if, it's when. We believe the focus on *when* is misplaced and overdone. What is far more important is the consequence of the FOMC's action to an investor's overall portfolio.[1]

THE MORE IMPORTANT ISSUE IS THE CONSEQUENCE OF THE FOMC's ACTION

No one knows the exact path of future interest rates – how much rates will rise over what time frame. When one examines the degree of accuracy of economists' (including the Federal Reserve's economists) interest rate forecasts, it is clear there has been far too little historical accuracy to have confidence in such forecasts. Their track record is little better than a 50/50 toss-of-the-coin. And that is not a disparaging remark. Rather, it speaks to the almost impossible task of predicting turns in the economy and markets, inflation rates, the price of oil, and interest rates. Understanding and accepting the limitations of such forecasting is a major component of risk management. How investors react (or over-react) to FOMC decisions, could be a greater risk than the FOMC's first step toward normalizing rates.

THE GREATER RISK IS HOW INVESTORS MIGHT OVER-REACT

It is a well-known fact among social psychologists that humans tend to over-react to headline news. That is especially true about market news and its attendant hyperbole. We envision two possible FOMC over-reaction risks: (1) the myopic focus and potential resultant over-reaction to the specter of rising rates/falling bond prices, which could obfuscate the greater risk of several more years of ultra-low bond income, (2) investors, out of frustration, capitulate and take on excess risk to get a little more yield.

[1] How investors and their advisors respond to FOMC policy is what matters. While there is a very high probability the FOMC will indeed raise rates before year-end, even that is unknowable. The increase in rates could be so small, so gradual, that it could have relatively little impact. That is another reason the *when* focus is over-done.

710 GREEN STREET | GAINESVILLE, GEORGIA 30501 | P: 770.718.0706 | F: 770.718.0805 | WWW. WICINVEST.COM

Rates rise slowly, bond prices fall little, and yields continue unattractive. When rates rise bond prices will fall. That is a bond mathematical property.[2] We believe there could be too much concern about what may be a small matter. The FOMC has gone out of its way to say over and over again it anticipates small rate increases over several years. Again, no one knows, not even the FOMC, what the path of rate increases will actually be. We believe it is a reasonable assumption, given the absence of inflation and under-employment, that rates will indeed slowly rise over the next several years. If so, the harm caused by rising rates to *total bond returns* (interest income plus price change) will be relatively minor, certainly manageable.

For example, assume a Walmart bond that matures 4/11/18 with a current yield-to-maturity of 1.05% (and a duration of 2.44). Generally speaking, if the FOMC raised rates 0.25% in December, and then another 0.25%, in February, that combined 0.50% rate hike would cause the Walmart bond price to decline approximately 1.22%.[3] That is not a significant "loss", and half a year of interest income (at 1.00%; so 0.50% for half a year) would offset about half of the loss. What if a year from now the FOMC has increased rates a full percentage point? In that scenario, we would anticipate the bond price would decline about 2.44% (about the amount of its duration), with one year's income at 1.00% resulting in a negative *total return* of approximately -1.44%. Our point is it is easy to get distracted and overly-focused on the well-publicized fact that rates are going up and bond prices are coming down. But what is the total return impact (bond interest income minus bond price "loss")? Might the negative total return be relatively insignificant? And if the bonds don't have to be sold, and if they mature within a few years, then the greatly feared "loss" should be temporary and of no real economic significance.[4]

The fear of rising rates/falling bond prices obfuscates **the potentially greater threat – bonds continuing to be of little value, of little utility, to many portfolios.** More than the risk of a small temporary "loss" in a bond's value, we are concerned there could be several more years of no meaningful income and an unattractive risk-reward trade-off with bonds.

Frustration leads to inappropriate risk-taking. Investors have already been taking on more risk with bonds by "reaching for yield" (investing in riskier bonds, bond-like-funds, certain ETFs, and alternatives). That is not new. If rates increase only 0.25 - 0.50 percentage points (as the FOMC has been suggesting), resulting in no meaningful increase in bank CD and money market yields, additional investors might capitulate out of frustration and likewise reach for better yields. Reaching for better yields in this environment often means taking on risks that are not really understood, not appropriate, or both.

---

[2] Bond prices change every day just like stock prices and follow certain mathematical properties based on interest rates, volatility, expected FOMC policy, inflation, time to maturity, coupon, etc.

[3] Generally speaking, a bond's price declines one percentage point for every point of duration. A half percentage point rise in rates (immediate parallel shift) would cause approximately a 1.22% decline in price of a bond with a 2.44 duration.

[4] WIC maintains a laddered or diversified maturity structure in its bond portfolios with most of our clients' bonds maturing within five years. We have the ability to hold to maturity.

Another risk is if the recent stock market volatility continues, many will decide they don't want to risk another 2008-2009 and will risk failure by taking on market-timing risk and move to cash. It is this reaction to several more years of no meaningful income from bonds and bank CDs that worries us more than the FOMC raising rates.

WIC's POSITION

Since 2009, we have minimized our clients' bond allocation; that has been very effective and we plan to continue that strategy. We continue to believe the bond risk-return trade-off is unacceptable; and we do not believe the historical hedge benefit of bonds vis-à-vis stocks will necessarily be significant in the coming years. When we evaluate the universe of investable asset classes, we continue to believe U.S.-centric, multi-national companies provide the best overall risk-return profile; that is why those companies (equities) will continue to be our focus. And for those clients where it is appropriate, we will continue to use *WIC's Managed Volatility and Income Strategy* (our long/short hedge strategy) as a complement or hedge to bonds.[5]

Disclaimers: *The views expressed represent the opinion of Willis Investment Counsel's research and portfolio management team. The views are not intended as a forecast or guarantee of future results. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment or strategy. Past performance is not predictive of future results, which may vary. Investing is subject to risks and uncertainties; future returns are not guaranteed, and loss of principal may occur.*

For more commentary, we invite you to visit our website at www.wicinvest.com.

Contact Information

WILLIS INVESTMENT COUNSEL
Principled Investing

710 Green Street
Gainesville, GA 30501
P: 770.718.0706 | F: 770.718.0805

[5] Depending on a client's circumstances, this strategy is used as a defensive equity strategy, as a complement or hedge along with bonds, as part of liability driven investing strategies with defined benefit plans, and/or for some clients (who are more risk tolerant) as a stabilizer or buffer vis-à-vis the equity component of the portfolio.