



*Structured Investing*

# PORTFOLIO PERSPECTIVES

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LORING  WARD

## The Pendulum Swings Both Ways

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Much attention has been focused on the extraordinary performance of fixed income investments as interest rates continued their decline in 2011. The combination of slow economic growth, low inflation and aggressive intervention by the Federal Reserve made long-term bonds the best asset to own over the last several years. Not only have long-term Treasuries outperformed stocks over the past decade, but long-term Treasuries have now also outperformed the S&P 500 Index for the 30-year period ending December 31, 2011.\*

While this may have created a feeling of “opportunity cost” for investors in shorter-term fixed income, it does not indicate a time for a change in fixed income strategy.

Let’s look at the factors that contributed to these extraordinary returns and then attempt to put them in perspective as we look to the future of fixed income investing.

Treasuries rallied dramatically during 2011, sending the yield on the 10-year Treasury down from a high of 3.77% on February 9 to 1.89% at the end of the year. The most significant shift downward occurred in the third quarter of the year, when 10-year Treasuries declined by more than 1.25%.

Ironically, this timeline coincided with several factors that should have led to an increase in rates based on the laws of supply and demand and the typical pricing function of the fixed income markets.

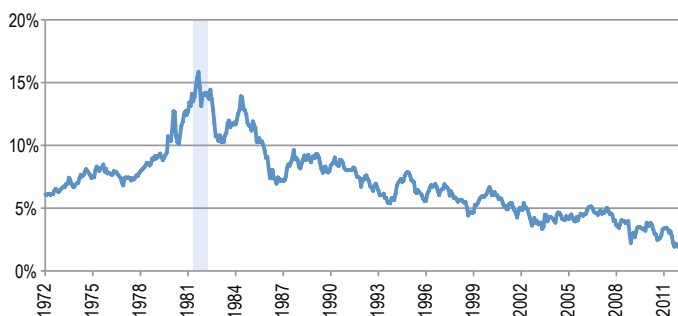
Going into the third quarter, many fixed income investors expected that the party would be over for fixed income once the Federal Reserve quantitative easing (QE2) came to an end on June 30. It was expected to create a disruption in supply and demand as the Treasury would continue to issue bonds to fund operations, but the Fed would no longer be creating artificial demand by buying Treasuries. The bond market’s response was the first in a series of counterintuitive moves. Interest rates rose very briefly after the announcement that QE2 would not be continued, and then quickly changed directions, beginning a decisive and steady march downward.

Then, the highly publicized debt ceiling fiasco raised concerns that the U.S. Government might default on its debt payments if the politicians could not come to an agreement to raise the debt ceiling by the August 2 deadline. Although the situation was ultimately resolved and the debt ceiling was raised on the deadline, Standard & Poor’s subsequently downgraded its rating of U.S. Treasury debt from AAA to AA+ on August 5. This is the first time America’s debt has ever been downgraded, but interest rates did not rise as would be expected when an issuer’s credit is downgraded. Instead, interest rates continued to decline, a clear testimonial that U.S. Treasury debt was still regarded as a “safe-haven” in the midst of a steepening European debt crisis and a sharply declining stock market.

Subsequent actions by the Federal Reserve also contributed to the continued rate declines. On August 9, the Fed announced its decision to keep the target overnight rate near zero at least through mid-2013. Then, on September 21, the Fed announced “operation twist,” a program to swap out of shorter-maturity Treasuries into longer-term Treasuries, with the stated objective of twisting the yield curve to stimulate lower longer-term interest rates. The operation produced the desired effect and drove long-term interest rates down even further to end the third quarter at 1.92%. Treasury yields were relatively stable through the fourth quarter, ending the year at 1.89%.

As we closed the year, one of the most intriguing headlines was “*Bonds Beat U.S. Stocks Over 30 Years for the First Time Since 1861.*”\*

### 10 Year Treasury Yield 1972 - 2011



Annualized Returns	One-Year	Ten-Year	30-Year
S&P 500 Index	2.11%	2.92%	10.98%
Barclays Long-Term Treasury Index	29.93%	8.95%	11.02%
U.S. Treasury Constant Maturity Index - 10 Years	17.15%	6.62%	9.55%

Data source: 10 Year Yield Yahoo! Finance (January 2012). Past performance is not indicative of future results. Indexes are unmanaged baskets of securities in which investors cannot directly invest; they do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio.

Some may interpret the higher return of long-term Treasuries as an indication that long-term bonds may be a better alternative to stocks for portfolio growth, with much less risk. In reality, stocks should offer better long-term return prospects than bonds.

Let’s take a closer look at these 30-year returns and examine the reasons why this occurred. First, it is important to understand that the results are very time-period sensitive, meaning that they are dependent on the conditions of the beginning and ending period measured.

We already know that 2011 was a rather unique year of unprecedented government intervention — creating price distortion from artificial demand for Treasuries — coincident with a global debt crisis. In the U.S., economic growth was slow, unemployment high and inflation tame, which enabled the Fed to continue to act aggressively.

But the year 1982, the beginning of the 30-year performance period, was also unique. It marked the end of the hyperinflationary period resulting from the oil crisis in the 70s. The 10-year Treasury yield began the year at 14.14% and ended the year at 11.67%, a decline of almost 2.5%. In fact, the Barclays Long-Term Treasury Index enjoyed the largest annual return in history, returning 41.47%! This also marked the beginning of a long-term declining trend in rates for the next 30 years.

When you consider the extraordinary decline from 14.14% to 1.89% over the 30-year period to generate an annualized return of 11%, you may realize that it is mathematically impossible for these fixed income returns to be repeated for the next 30 years. Even if rates go down all the way to zero, it would only be a decline of 1.89% vs. a decline of 12.25% since 1982.

*“The rally in bonds is a once in a millennium event, but it’s absolutely mathematically impossible for bonds to get any kind of returns like this going forward...If you missed the rally in bonds, well, then that’s it.”\**

JEREMY SIEGEL  
 Finance Professor at Wharton School  
 at the University of Pennsylvania

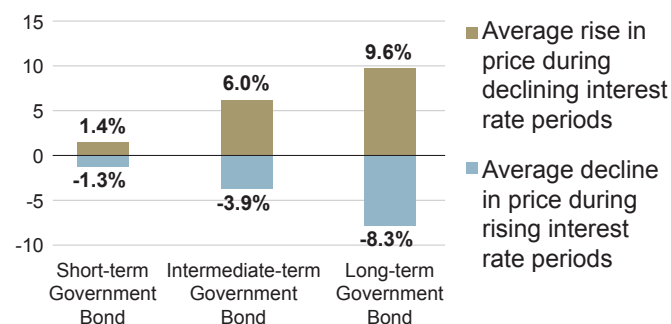
Further gains may be negligible, since real yields on 10-year Treasuries are already negative. This is not to say that rates will not decline further, but even if they did, the upside to investors is very limited while the downside risk is much

greater. There is actually greater risk of a change of direction in interest rates, given the current level. This could happen in two years or ten years, we just don't know. But rates can only decline by 1.9% to zero to provide positive returns on principal, while there is no limit to how high they can rise which would generate losses on principal. Imagine if we experienced the 1982 rates of 14.14%?

It is important to remember that the pendulum that delivers returns swings both ways. The instruments that performed best during recession and flight-to-quality periods — long-maturity Treasuries — may perform worse during an economic recovery and/or an inflation-driven bond market decline. As the chart below shows, long-maturity Treasuries typically experience the steepest price adjustments in bond market cycles.

### Fixed Income Maturity Risk

1970 - 2010



Note: Bonds and fixed income funds will decrease in value as interest rates rise. Short-term government bonds are represented by the one-year U.S. government bond for 1970-2011. Intermediate-term government bonds are represented by the five-year U.S. government bond and long-term government bonds by the 20-year U.S. government bond. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. The data assumes reinvestment of all income and does not account for taxes or transaction costs. For the annual periods 1970 through 2008, each year was categorized as a year when yields rose or a year when yields fell. The price changes during all years when yields rose were then averaged. The same was done for years in which yields declined. The price change was isolated, as opposed to the total return, so that the effect would be more pronounced. ©2009 Morningstar, Inc. All rights reserved. 3/1/2011

Long-term bonds are more interest rate sensitive, which means they should deliver the strongest returns when interest rates decline, but they should also deliver the worst returns when interest rates rise. The chart above shows the average return of short, intermediate and long-term bonds during

periods of declining rates and periods of rising rates.

Shorter-term fixed income mutual funds may also benefit from a rising rate environment by reinvesting maturing bonds at higher coupon rates and thereby potentially increasing income returns — often high enough to offset any price declines.

To highlight these risks, let's look at the performance of the Barclays Long-Term Treasury Index vs. the Barclays Treasury 1-5 Year Index during periods of rising rates within the last 30 years. Even with the long-term trend of declining rates over the last 30 years, there were five short periods when interest rates rose and long-term bonds generated significant losses, as compared to the shorter-term index. The returns of the long-term index during these periods ranged from -5.5% in 1986/87 to -12.92% in 2009. By comparison, the returns for the 1-5 year index were positive for all years, with the exception of a negative return of -1.34% in 1994.

### Fixed Income During Periods of Rising Rates

Annualized Returns	05/1983 to 05/1984	05/1986 to 09/1987	02/1994 to 10/1994	10/1998 to 10/1999	01/2009 to 12/2009
S&P 500 Index	-3.30%	28.73%	0.21%	32.72%	26.46%
Barclays Long-Term Treasury Index	-10.20%	-5.50%	-11.70%	-7.05%	-12.92%
Barclays Treasury 1-5 Year Index	5.10%	4.96%	-1.34%	2.15%	0.19%

Data source: 10 Year Yield Yahoo! Finance; DFA Returns 2.0. (January 2012). Past performance is not indicative of future results. Indexes are unmanaged baskets of securities in which investors cannot directly invest; they do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio.

The downside risk and additional volatility associated with long-term bonds is the primary reason that we invest only in short-term fixed income. We believe the role of fixed income is to dampen volatility generated from equities in a portfolio.

With current interest rates at historically low levels, investors may feel the temptation to extend their investments out in maturity in search of higher yields, or in hopes of participating in the higher returns achieved by longer-term

fixed income over the past several years. It is important to resist the temptation. Don't lose sight of the risks in fixed income, and most importantly, don't lose sight of your long-term portfolio strategy. Fixed income should not be looked at in isolation, but rather in the context of its role in a total portfolio strategy.

**Note:** *Diversification does not guarantee a profit or protect against a loss.*

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**References:**

\**Bonds Beat U.S. Stocks Over 30 Years for the First Time Since 1861*", by Cordell Eddings, Businessweek (November 2011) <http://www.businessweek.com/news/2011-11-08/bonds-beat-u-s-stocks-over-30-years-for-first-time-since-1861.html>