ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

March 16, 2012

In This Issue

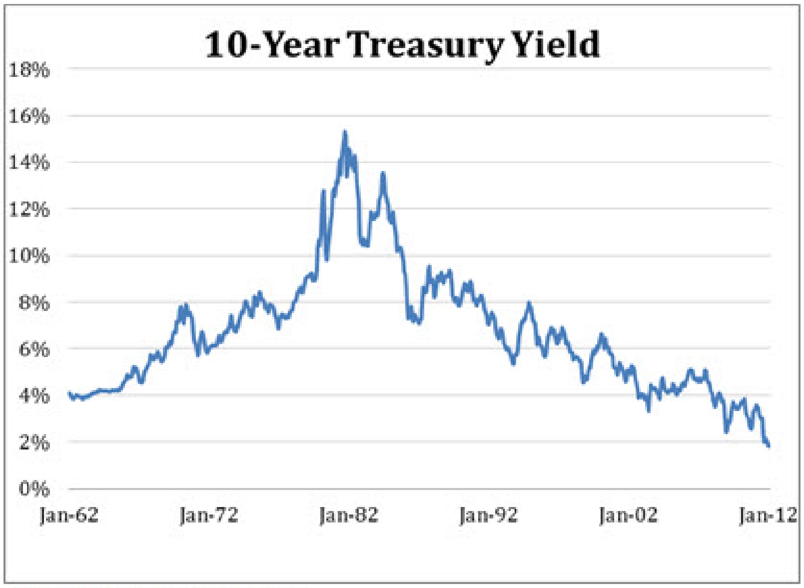
Is Your Portfolio Ready for Rising Interest Rates?

With the economy gaining momentum in recent months, some are speculating that the Federal Reserve may be forced to start raising short-term interest rates sooner than expected. To date, the Fed is on record as stating that it expects to keep rates near zero through late 2014. But a robust economy, coupled with rising oil and gasoline prices, could lead to a spike in inflation. If that were to happen, the Fed might be forced to abandon its low-interest-rate policy.

That would be bad news for investors who piled into bonds during the bear market, as bond prices fall when interest rates rise. After rallying strongly in 2011, bond yields are near historic lows. At the beginning of 2011, the yield on the 10-year Treasury bond stood at 3.31% and in recent days it was yielding about 2.14%. Given how low yields are today, we thought it would be instructive to examine how bonds have held up during previous periods of rising interest rates.

The chart below, which maps the yield on the benchmark 10-year Treasury bond over the past 50 years, provides some perspective on just how far interest rates have fallen. Most investors today, even those who have been investing since the early '80s, have only experienced the steadily rising prices (and declining yields) of a bull market for bonds.

Of course, interest rates could reverse direction and trend upward over a period of many years as well. As this chart also shows, bond prices fell and interest rates rose in the 20 years prior to 1981.



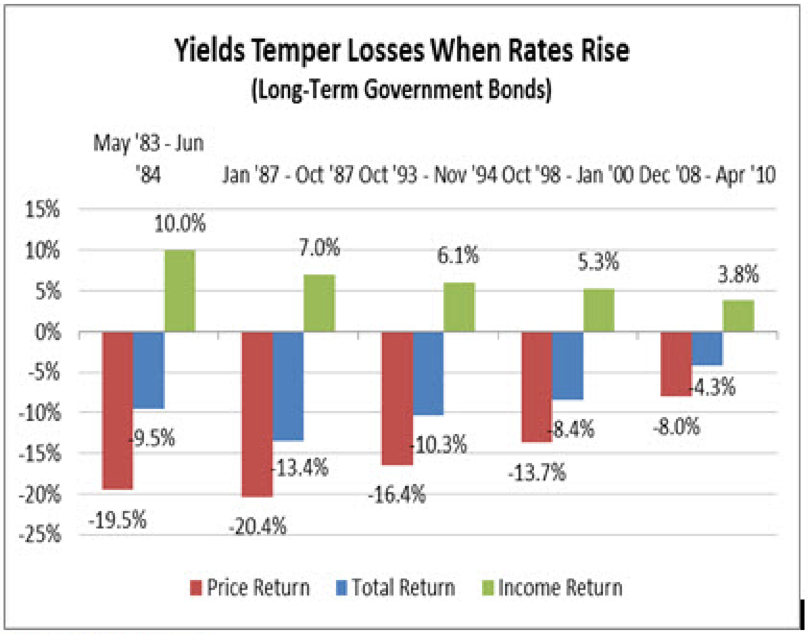
Source: Federal Reserve

Looking forward, the question for bond investors is whether we are on the cusp of a new bear market in bonds, or whether yields will remain low for years to come. Several well-known pundits have been forecasting a rise in interest rates in each of the past several years, but the opposite has occurred. However, if this prediction does eventually turn out to be correct, many bond investors could be in for some pain.

That's because investors today are probably more highly exposed to the risks of rising interest rates than they have ever been. After a 30-year bull market in bonds, many still cannot seem to get enough bonds into their portfolios. More than $750 billion has been plowed into bond funds over the past three years, while investors pulled more than $115 billion out of stock funds over the same period. During this time, interest rates went from record lows to new record lows. This is noteworthy, because, with yields so low, the relatively meager income investors are receiving does not provide much cushion from the impact of rising interest rates.

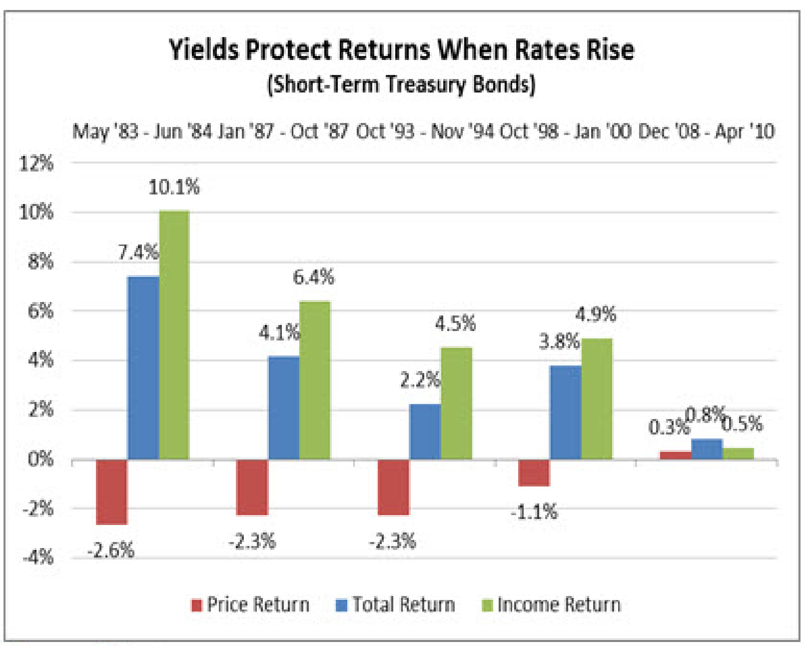
The two components of a bond's total return are price changes and income (or yield). In the chart below, we have graphed both the price return and the total return of long-term government bonds (those with maturities of about 20 years) during different periods of rising interest rates.

The difference between the price return (the red bar) and the total return (the blue bar) is the income return (the green bar). You can see that the positive income return helped to cushion the losses from falling bond prices, but long-maturity bonds still suffered significant losses in each period of rising interest rates.



Source: Ibbotson

By contrast, the chart below shows that the impact of rising interest rates on short-term bonds (in the chart, those with maturities of around one year, although the term "short-term" can refer to bonds with maturities of up to five years) was far less dramatic. While bond prices fell in all but one of the five periods displayed, income yields more than made up for the difference, and short-term bonds still produced positive total returns in each period.



Source: Ibbotson

Balancing Risk and Reward in a Rising-Rate Environment
Just as it's impossible to predict which way the stock market will

move, nobody can predict whether interest rates will rise or fall in the future. But that doesn't mean investors should not be prepared for higher interest rates. For example, if interest rates were to increase by just 1%, the price of the 10-year Treasury would fall about 7%, and other types of bonds would also experience price declines of varying amplitude.

Given the big run-up in prices for long-maturity bonds in 2011, investors should determine whether they are comfortable with the risks of owning these bonds if interest rates were to rise. As the charts above demonstrate, a bond portfolio that tilts towards shorter-maturity holdings may help temper the risk of rising rates.

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