Financial Services Advisory
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The Bond Market and Navigating Rising Rates

December 8, 2017

The future course of interest rates is a topic of much attention lately, as the economy continues its slow but steady recovery from the financial crisis of 2008. How quickly rates may rise is open to debate, but the general consensus seems to be that they are heading higher and the period of historically low interest rates we've experienced is likely coming to an end. Even the suggestion of such a change can cause angst in the bond market, as investors fear that the value of their current bond holdings will decline. But there's more to the story than the prevalent idea that as interest rates rise, all bonds will fall. As with anything in life, it's not that simple.

FSA invests the fixed income portion of client portfolios in bond mutual funds rather than individual bonds. Like stock mutual funds, bond funds invest in a basket of individual bond holdings that are professionally managed. Here are some things to keep in mind as interest rates may rise in the year ahead:

How do I know if my portfolio includes bonds? The answer to that question depends on the FSA strategy you and your advisor have chosen based on your investment profile. The table reflects the allocation to bond funds in the various FSA strategies, as of the end of November:

STRATEGY	Allocation to BOND FUNDS as of 11/30/17
Income	95%
Income & Growth	40% to 45%
Conservative Growth	20% to 25%
Core Equity	0%
Tactical Growth	0%

Note: Portfolios are managed individually and may differ from these allocations.

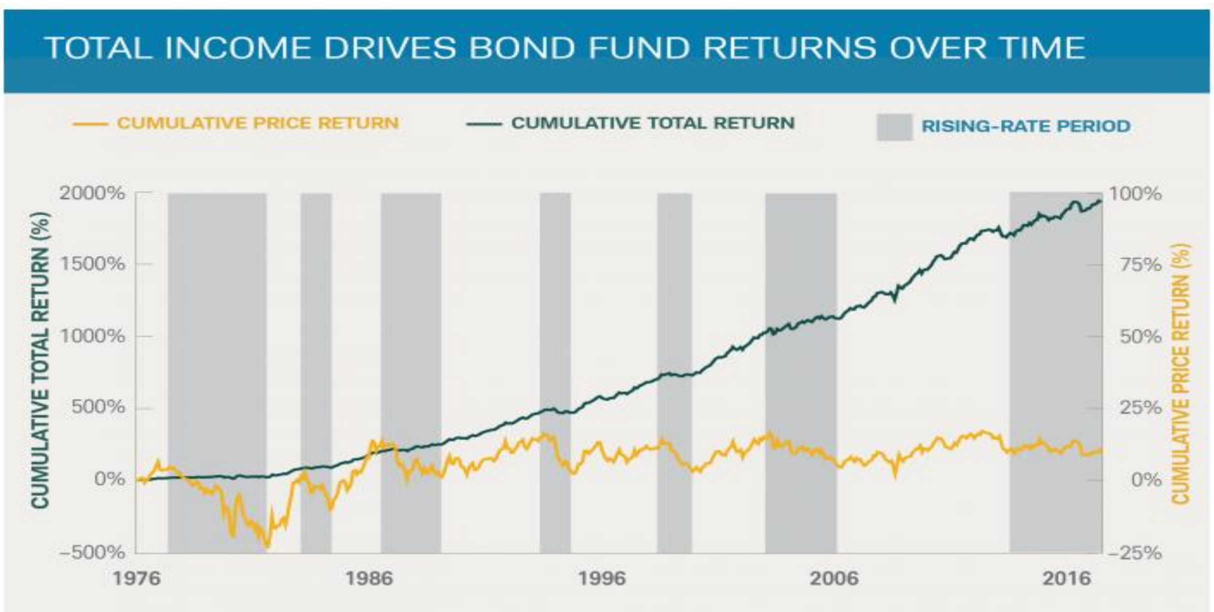
Generally, the more conservative the investment strategy, the higher the allocation to bond funds in the portfolio, as fixed income has historically acted as a ballast to offset the volatility that may be present in the stock market. If you have portfolios in one or more of our more conservative strategies, the next item is a key point to remember.

Not all bonds are created equal. The same is true for bond funds. Will all bond funds behave the same way and fall in value when interest rates are rising, as investors generally assume?

The answer is no. Some bond funds invest in lower quality corporate bonds, which tend to rise along with stocks. Other bond funds invest in floating rate bonds, which are more resilient in an environment of rising rates and may actually rise in value. Short-term bond funds will hold their value better than long-term bond funds. In other words, the best way for fixed-income investors to navigate a period of rising rates is to gravitate toward the types of bonds that will hold up better and still provide needed income, which brings us to the last key point.

It's not all in the price. Fixed-income investors typically worry that the price of their bond holdings may decline as interest rates head up, but that's only part of the equation. The return that fixed-income investors hope to gain from owning bonds comes not so much from price appreciation of the bond, but from dividends received in the form of regular interest payments.

As the chart below shows, during periods of rising interest rates (dark gray boxes), the income component of owning bonds can offset some of the declines from the bonds themselves, so that the overall total return from bonds in a period of rising interest rates can be mildly negative or even positive. For example, the worst year for bonds over the past 30 years was 1994. The intermediate-government bond index fell 11% that year, but because the bonds paid income that amounted to 6% over the course of the year, on a total return basis, a bond investor only lost 5% on her investment.



Source: Schwab Center for Financial Research with data from Barclays. Returns shown are from monthly Bloomberg Barclays U.S. Aggregate Bond Index returns from January 30, 1976, through September 29, 2017. Total return equals income plus change in price with a reinvestment of interest payments. Rising-rate periods are defined as those in which two-year Treasury bond yields increased by 40% or more over the course of at least 16 months. **Past performance is no guarantee of future results.**

So, what is the key point to take away from all of this? One shouldn't assume that all bond funds will behave the same way when interest rates rise.

On another topic, as the end of the year draws near, we want to point out that, as usual, most mutual funds—particularly stock funds—pay capital gains distributions in December. Some of you might recall this annual ritual from years past. We offer this reminder because when a fund pays a distribution, the price of the fund drops to reflect the payment, but the distribution is not received by the custodian (Charles Schwab) until the next day. When the distribution is paid into your account, the value of that fund holding will be adjusted upward to reflect receipt of the distribution.

If you have any questions about your accounts or if you would like to make changes to your specific investment strategies, please call or email your advisor.

We wish you a wonderful holiday season and a happy New Year!

Mary Ann Drucker
Assistant Portfolio Manager

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