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Waiting for Rates to Rise

Overview: Waiting for rates to rise is a risky strategy for at least two reasons: Interest rates are difficult to predict, and unbeknownst to most investors, current fixed income market prices already account for significant increases in interest rates.

Since interest rates started dropping in late 2007, one question investors have repeatedly asked is why does it make sense to own intermediate-term bonds if rates are likely to rise? Let's look at two key aspects of this question.

First, other than very short-term interest rates that are heavily influenced by the Federal Reserve, changes in interest rates are difficult to predict. Second, to determine whether a short-term fixed income approach will be superior to an intermediate-term fixed income approach, you need to know rates will rise *and* that they will rise by more than what the market already projects. This second point is one of the most fundamentally misunderstood concepts when it comes to fixed income investing.

Predicting Interest Rate Movements

Few subjects in investing have been studied more than whether changes in interest rates are predictable. Obviously, the ability to correctly predict such changes would be enormously valuable, but research continually shows that doing so is virtually impossible.

For example, a cursory statistical analysis of changes in five-year Treasury yields over the 60-month period ending in February 2011 shows that changes in interest rates from one month to the next are practically uncorrelated.¹ This brings us to the first risk associated with waiting for rates to rise: It is very difficult to know when rates will rise. In Japan, for example, interest rates have been well below their long-term average for well over a decade.²

Understanding Market Expectations for Interest Rate Increases

Using current market interest rates, let's compare two investment strategies covering the next four years:

1. You can buy a four-year bond with an expected return of 1.80 percent per year and hold it until maturity.
2. You can buy a two-year bond with an expected return of 0.80 percent over the next two years, hold it until maturity and then buy another two-year bond and hold it until maturity.

A simple question to ask is when will the first strategy produce higher returns than the second strategy and vice versa? Crunching the numbers reveals that the only way the second approach will come out ahead is if the expected return on the second two-year bond that you purchase is greater than 2.80 percent. So for the second strategy to outperform the first strategy, interest rates on two-year maturity bonds must increase by more than 2 percent.

As this simple example shows, even knowing interest rates will increase is not sufficient. You also need to know whether they will increase by more than what the market has already accounted for.

Conclusion

Investors can benefit from taking minimal credit risk in their fixed income portfolios and generally keeping their portfolios fairly short term in maturity. However, this does not mean investors should keep everything in cash and very short-term fixed income at all times. In environments in which the yield curve is steep, which is certainly the case at this time, moving out a bit longer in maturity with a portion of your fixed income portfolio can make sense.

¹ Five-Year Treasury Bellwether Index. Available at <https://live.barcap.com>. Accessed March 11, 2011.

² GJGB10 Index. Available through Bloomberg terminal. Accessed March 11, 2011.

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