THE RISKS OF PERCEIVED SAFETY IN SHORT MATURITY FIXED INCOME

Rick Harper — CIO, Fixed Income
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Over the past several months, we have talked a great deal about how falling interest rates have altered the risk-return trade-offs within the bond market. Over the last several years, falling rates have not only lowered the potential income cushion, but also increased the degree of sensitivity to changes in interest rates. In 1994, the Barclays U.S. Aggregate Index (Agg) offered a yield of 5.87% and duration of 4.78 years. Today, the Agg has a yield of 2.20% and duration of 5.5 years.[1] That's a 3.67% decrease in cushion to protect against an even greater sensitivity to interest rate risk. As a result, losses from rising rates could have the potential to be more severe on a total return basis as the Federal Reserve (Fed) begins to normalize policy in the coming months. In response to this risk, many investors have flooded into the short end of the yield curve in an effort to reduce risk in their portfolios. However, we believe this could be problematic as the Fed begins to shift policy. The logic of the last year seems well founded: If investors are concerned about rising interest rates, take less interest rate risk. In retrospect, the timing of this trade was too early. Even as the Fed transitioned from tapering and tightening, longer-term interest rates continued to fall. As a result, investors have missed out on income and decreases in rates even after the Fed concluded its tapering program. The yield sacrifice was painful, and being short the benchmark in a falling rate environment never sits well with clients. But with the Fed starting to lose patience with zero interest rates, greater attention should be paid to the risk-return dynamics of the front end of the curve. The bottom line is that income levels are very low, possibly too low, to provide adequate protection if the Fed tightens earlier or more aggressively than anticipated by the market. **What's Past Is Prologue** In order to understand the likely market reaction to a shift in Fed policy, we examine the three previous tightening cycles to understand how the market reacted six months prior to a Fed rate hike and after. A quick comparison of current market pricing relative to the past three tightening cycles highlights the relatively low income cushion currently offered by 2-Year Treasuries.[2] • The amount of cushion before the 1994, 1999 and 2004 tightening periods was 6.5x, 7.25x and 2.75x current levels, respectively. • In previous tightening periods, investors pushed the 2-Year yield even higher in the months preceding the initial hikes to increase that cushion. As we show in the table below, 2-Year interest rates will adjust well in advance of any change in Fed policy. In fact, comparing the yield six months before a change in policy shows that rates rise by approximately 100 basis points (bp), on average. While it could be debated that this rise in yields is also estimation about the terminal level of interest rates, the fact remains that investors seeking safety in the short end of the yield curve will likely be adversely affected by a rise in short-term interest rates. **Yields and Total Returns of 2-Year Treasury Notes during Past**

6 months before the first hike	8/4/1993	12/29/1998	12/29/2003	Current, 2/28/2015
2-Year Treasury Yield	4.16%	4.66%	1.78%	0.62%
Fed Funds Target	3.00%	4.75%	1.00%	~ 0-25%
Difference	1.16%	-0.09%	0.78%	0.37%-0.62%

Day before the first hike	2/3/1994	6/29/1999	6/29/2004	Current, 2/28/2015
2-Year Treasury Yield	4.28%	5.68%	2.81%	0.62%
Fed Funds Target	3.00%	4.75%	1.00%	~ 0-0.25%
Difference	1.28%	0.93%	1.81%	0.37%-0.49%

Cumulative Returns for Barclays 2-Year U.S. Treasury Bellwether Index

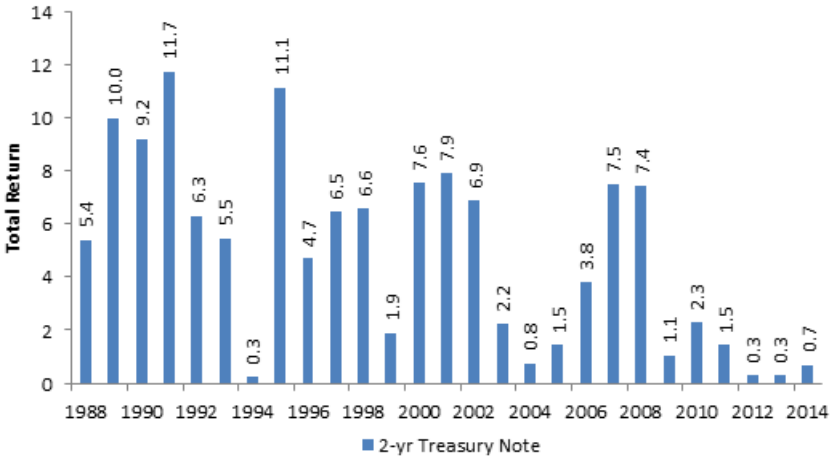
6 months before the first hike to Last Hike	8/4/1993 2/1/1995	12/29/1998 5/16/2000	12/29/2003 6/29/2006
Price Return	-4.62%	-4.48%	-4.99%
Income Return	7.96%	7.63%	8.02%
Total Return	3.34%	3.15%	3.03%

Tightening Period	2/4/1994-2/1/1995	06/30/1999-5/16/2000	6/30/2004-6/29/2006
Cumulative Price Return	-4.53%	-2.53%	-3.94%
Cumulative Total Return	1.35%	2.73%	3.26%

Source: Bloomberg, as of 2/28/15. Past performance is not indicative of future results. You cannot invest directly in an index.

Tightening Periods

For definitions of indexes in the chart, visit our glossary. While the magnitude of the rise in rates is not particularly surprising, one of the most interesting elements of previous tightening cycles is shown in the bottom table. **In the previous three tightening cycles, the 2-Year Treasury Index posted positive returns solely due to the level of income cushion.**[3] Price returns were remarkably similar over these previous tightening cycles, despite their differing lengths of time. However, the key takeaway is that income returns allowed investors to avoid negative total returns. Given that this cushion has largely been diminished in the current environment, we believe it is unlikely investors will be able to avoid losses in short duration fixed income strategies if the Fed is earlier or more aggressive than the market anticipates. As we illustrate in the chart below, investors should keep in mind that 2012 and 2013 were the two worst performing years for the 2-Year Treasury dating back to 1981.[4] In 2012 and 2013, price returns contributed 4 bp and 8 bp to the overall return. The annual price returns for 2004, 2009 and 2014 were -5.315%, -3.34% and -1.46%, respectively. The corresponding income returns were 5.57%, 5.34% and 2.09%. What will performance look like if the Fed surprises the market? How will investors react to potential negative returns in their short maturity bond funds? **2-Yr Treasury Note**



Source: Barclays, as of 12/31/14. Past performance is not indicative of future results. You cannot invest directly in an index.

While we believe that reducing interest rate risk in front of a change in Fed policy is prudent, focusing singularly on the short end of the yield curve may leave

investors disappointed. In our view, a more prudent approach may be to hedge interest rate risk via zero and negative duration fixed income strategies as opposed to simply shifting to the short end of the curve. [1]Source: Barclays, as of 12/31/1994 and 2/28/2015, respectively. [2]Source: Bloomberg, as of 2/28/15. [3]Source: Barclays. [4]The inception of the 2-Year U.S. Treasury Bellwether Index. Source: Barclays, as of 2/28/15.

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DEFINITIONS

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

Basis point : 1/100th of 1 percent.

Short Maturity Bond Fund : a Pool of securities that invests in fixed income securities with maturities less than year.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Barclays 2- Year U.S. Treasury Bellwether Index : tracks the performance and attributes of the most recently issued, or on-the-run, 2-Year U.S. Treasury.