FED POLICY: FROM TAPERING TO TIGHTENING

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Over the past nine months, the Federal Reserve (Fed) has gradually reduced the pace of its asset purchases in conjunction with an improvement in the strength of the U.S. economy. With "tapering" expected to end October 29, we believe that investors should now look beyond 2014 and start to focus on when, not if, the Federal Reserve will raise the Federal Funds Rate. In our view, the way that investors have prepared their portfolios for tapering will be inadequate for the likely market reaction to increases in short-term rates. In this blog post, the first of a series on this topic, we focus on the performance of traditional fixed income and rising-rate alternatives as the Fed begins to shift policy. **Performance Review of Traditional Approaches to Rising Rates** When Fed Chairman Bernanke introduced the prospect of Federal Reserve tapering in May 2013, market pundits began to debate whether tapering was akin to a tightening of monetary policy. More than one year later, we can look back with the benefit of hindsight and conclude that tapering was in fact **not** tightening. However, as the market grappled with this question, we observed a meaningful test run for rising rate strategies that could prove useful when fears of tightening resurface. In the initial months following Bernanke's comments, rates rose rapidly, catching many investors off-guard. When tapering didn't occur as early as feared, short-term rates retraced while longer-term rates remained elevated. Unfortunately for investors, while most traditional approaches for reducing interest rate risk were able to generate positive returns, the magnitude of those returns paled in comparison to losses experienced in other parts of their bond portfolios. As shown in the table, traditional approaches to rising rates during the "taper tantrum" managed only to avoid losses, as opposed to meaningfully contributing to portfolio returns. In our view, this poses a significant problem for asset allocators. When thinking about the role that fixed income has traditionally played in a balanced portfolio, these shorter-duration strategies provide very little income potential to dampen equity volatility. Fortunately for investors, equities continued to rally through the end of the year.

	Taper Tantrum	Actual Tapering	Entire Period		
	5/22/13 – 12/18/13 (211 days)	12/18/13 – 8/31/14 (256 days)	5/22/13 – 8/31/14 (467 days)		
Traditional Fixed Income	**Total Return (%)**	**Total Return (%)**	**Yield Change (bp)**	**Total Return (%)**	**Current Yield to Maturity (%)**
U.S. Two-Year Treasury	0.29%	0.49%	+25.4	0.78%	0.49%
U.S. Five-Year Treasury	-1.58%	1.35%	**+80.6**	-0.25%	1.63%
U.S. Ten-Year Treasury	**-6.35%**	**6.94%**	+41.7	0.15%	2.34%
Barclays U.S. Aggregate Bond Index	-1.84%	4.55%	+32.0	**2.62%**	2.22%
Rising Rate Alternatives	**Total Return (%)**	**Total Return (%)**	**Yield Change (bp)**	**Total Return (%)**	**Current Yield to Maturity (%)**
Cash (Barclays 1-3m T-Bill Index)	0.02%	0.02%	-1.0	0.04%	0.02%
Barclays U.S. Aggregate Index, 1-3 Year	0.42%	0.61%	**+24.0**	1.04%	0.73%
Barclays U.S. Dollar Floating Rate Note (FRN) Index	**0.49%**	0.74%	-12.0	1.23%	0.52%
Barclays US Aggregate Zero Duration Index	N/A	**1.51%**	N/A	N/A	0.46%

Sources: Barclays, Bloomberg, as of 8/31/14. Performance information limited for the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration due to real-time index data availability. Past performance is not indicative of future results. You cannot invest directly in an index.

Shifting the focus of the analysis to the period of actual Fed tapering that began December 18, 2013, we see that traditional fixed income performed well as longer-term rates fell in 2014. Curiously, rising-rate strategies provided very similar returns to those experienced during the "taper tantrum." This can largely be explained by the fairly muted rise in interest rates at the short end of the yield curve. During both periods, income potential was the primary driver of returns. As a result, total returns remained constrained but positive. **Tapering vs. Tightening** In our view, returns experienced during the "taper tantrum" represent a possible best-case scenario for traditional rising-rate strategies. Over that time, longer-term interest rates rose while short-term rates remained contained, helping to insulate investors from losses that reduced interest rate risk. When the market becomes more concerned about the timing of the first Fed rate hike, this portion of the yield curve, where investors formerly sought safety, could come under considerable pressure. At current income levels, the margin for error remains extremely low. As an alternate approach, we also illustrate how a duration-hedged approach performed since the Fed began tapering. In this strategy, Barclays Rate Hedged U.S. Aggregate Zero Duration Index is exactly the same as the traditionaBarclays U.S. Aggregate Index, but a second-step adjustment seeks to hedge interest rate risk to zero. As a result, investors were able to maintain traditional bond exposures while reducing interest rate risk. With hindsight, we know that hedging interest rate risk detracted from returns as rates fell during Fed tapering. However, when compared with traditional rising rate alternatives, this approach, demonstrated

by the Barclays Rate Hedged U.S. Aggregate Zero Duration Index generated significantly better performance. In subsequent blog posts in this series, we will discuss similar approaches to managing interest rate risk in greater detail. Ultimately, the timing of changes in Fed policy remains far from certain. However, with Fed tapering largely a foregone conclusion, investors should begin to prepare their portfolios for the next move in Fed policy.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

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

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Short-term rates : the rate of interest on a debt instrument maturing in two years or less.

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.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

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.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

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.

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