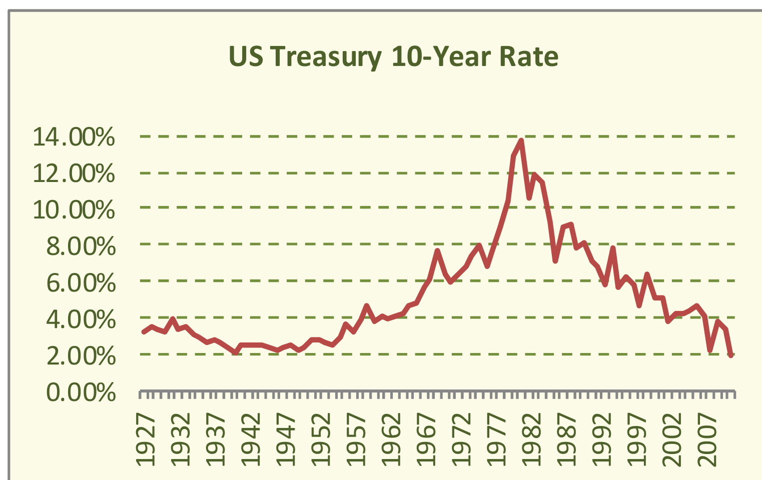
Don't be caught by surprise: Interest rate changes and your portfolio

We are in the home stretch of an unprecedented bull market in bonds that has lasted three decades and investors have enjoyed the boost in bond prices as US Treasury 10-year interest rates have fallen from 14% in 1981 to below 2%, reaching all-time lows. It is important to be cognizant of the effect fluctuations in interest rates can have on the bond market. A seemingly small move up or down in rates can have a dramatic impact on prices. Investors holding bonds with high coupon rates have reaped the benefits as the current rates have dropped. This is a double edged sword and as interest rates increase, investors holding bonds with lower rates will see the value drop. Consider the example below of an investor holding a US Treasury 10-year bond with a 3% yield. If rates went up to 4% or 5%, you can see how quickly the value drops.



*Source data: Federal Reserve Economic Data (FRED)

Face Value	Years	Coupon Rate	Market Rate	Current Price	% Price Loss
$ 1,000	10	3%	3%	$ 1,000	0%
$ 1,000	10	3%	4%	$ 918	-8.2%
$ 1,000	10	3%	5%	$ 844	-15.6%

The majority of investment firms are continuing to squeeze what they can out of the bond market before what has been termed the "great rotation" out of bonds and into stocks. The debate among investment professionals is not centered around "if" rates will begin to rise, but rather "when" the rise will begin. The Federal Reserve indicated during Ben Bernanke's speech on November 20 that it expects to keep interest rates low in the short to intermediate term.

Many risk averse investors have become complacent in their bond portfolios while focusing solely on the promised interest rate. However, expanding on our example above, dramatic effects on bond prices as a result of a small increase in interest rates can result in unanticipated downside risk on total return. As an example, we can take a look at the table to the right and see the rate increase from 10.39% in 1979 to 12.84% in 1980. Bond prices dropped almost 16%, resulting in a negative return despite the healthy coupon payments. A negative 3% return while having a coupon over 12% is a major impact. A possibility that needs to be considered is the effect on total return to investors on similar interest rate increases when their coupon is only 2%.

Year	US 10Yr Interest Income	Contribution of Price Change on Returns	US 10Yr: Total Return
1979	10.39%	-9.72%	0.67%
1980	12.84%	-15.83%	-2.99%
1981	13.72%	-5.52%	8.20%

There is no guarantee that interest rates will change in the future. Fixed income markets can be volatile and investors may lose money.

The chart below displays three data points we can use to demonstrate the relationship between increasing interest rates and decreasing bond prices. The red line is the annual interest rate over time. The grey line represents the total return and the shaded line represents the contribution bond price changes had on total return.

During the long upward rate cycle, the associated price change in bonds created substantial drag on bond returns to the point where returns were routinely lower than the rate of inflation. After the peak, we consistently see how current bond holdings enjoyed healthy price increases as rates declined. At some point in the intermediate term, we expect the trend to mimic the upward interest rate cycle and we will see the corresponding adverse effect on bonds prices as a result.

Effect of Interest Rate Changes on US Treasury 10-Year Returns

Rising rates led to considerably more downward pressure on returns

The downward rate environment has significantly bolstered returns

35.00%
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%

1927 1934 1941 1948 1955 1962 1969 1976 1983 1990 1997 2004 2011

Contribution of Price Change on Returns
US Treasury 10-Year: End of Year Return
US Treasury 10-Year Rate

*Source data: Federal Reserve Economic Data (FRED)

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