



March 18, 2010

Is Your Bond Portfolio Ready for Higher Rates?


With the U.S. economy beginning to show some faint signs of recovering from the worst recession since the Great Depression and interest rates at levels not seen since the 1950's, the reality of rising rates is on the horizon. When interest rates go up, bond prices go down, a very predictable characteristic of market cycles. In spite of the threat of higher rates and potential price volatility, the investor public has continued to dump new dollars into bond funds at historical levels. According to The Investment Company Institute investors have over \$2.2 trillion dollars in bond mutual funds, with nearly \$400 billion dollars poured into bond funds since the beginning of 2009. As a point of reference, the amount of new money shifted to bond funds the last 12 months equals nearly the total amount of money that went into bond funds the previous 10 years. With taxable money fund yields at a record low of 0.02% for the fifth consecutive week, this shift is not a surprise. But does this rush to bond funds have the signs of the next "bubble"? A very good question! For those statistically minded, it is interesting to note that Citigroup's Chief equity strategist in December called investors stampede into fixed income "quite worrisome", with net bond fund cash flow nearing "three standard deviations above the average". This is a level of risk so far from normal that you might expect to see it just one percent of the time."

Higher interest rates are not going devour us tomorrow and most likely will not begin to move higher until early next year. The economy is still very fragile and the risk of a reoccurring recession (W) is a possibility. But one thing is for certain, rates will rise in the future. Interest rates are at multi-decade lows and the Fed has injected historic levels of liquidity into the markets. The U.S. issued more debt in 2009 than was issued from the George Washington to Ronald Reagan era. Although the Federal Reserve has yet to telegraph that rate increases are imminent, some rates in the Treasury market have already moved higher. At the end of 2008, the 10 year U.S. Treasury bond rallied to a multi-decade low yield of 2.2%, powered by the flight to quality in the height of the credit crisis. By the end of 2009 the yield had moved to 3.95% causing a price decline of 12.33% for the year. When the higher rate cycle begins history tells us increases can occur quickly. In 1994 the Fed raised the discount rate 9 times from 3% to 6% in a 12 month period. The 30 U.S. Treasury Bond yield went from 6.2% to 8% and the bond price declined 19%



Yield chart for the 30 year U.S. Treasury Bond in 1994

At the bottom of the last rate cycle in 2004 the Federal Reserve raised the Fed Funds rate 17 times in 24 months. Fed rate increases are driven by the health of the economy and is how the Fed fights inflation. The timing and velocity of this next cycle will be driven by the current economic recovery and obviously influenced by the high current rate of unemployment.



Fed Funds 2004-2006

The time to make bond portfolio adjustments is before Fed rate hikes gain momentum

Year	Rate (%)
2004	1.00
2005	2.25
2006	5.25

The Fed raised rates 17 times in 24 months in the last rate cycle



Proper security selection in a rising interest rate environment is critical. The longer average maturity that your portfolio has the more risk you are taking. Mistakes can result in severe long term damage to an investor's portfolio. Locking in longer maturities will not allow a portfolio to increase its yield without taking losses in those positions. In this cycle it is critical to also understand the size of the bond mutual marketplace is several times the norm. An uptick in rates could send many investors to the sell window in an effort to shorten up maturities. This could cause liquidity issues and volatility in the current overbought mutual fund bond market.

Historically, Fed rate hikes hurt bond market returns with the majority of the damage in the intermediate and longer end of the maturity range. When the Fed raises rates on the overnight cost of money it filters thru the entire fixed income market and causes all bond yields to increase.

The good news is that rates have not yet started their move higher and the bond market is at the tail end of a 28 year bull market that started in 1981 when the Fed Funds rate was at 19%. This means that investors fixed income positions should be for the most part at or above their cost. Maturity adjustments can be made now with little if any principal impact. Once rates begin to rise this can change very quickly. The time to review and adjust is now! Shortening your bond portfolio's average maturity, whether you are in individual issues, funds or ETF's, will pay off in the future. When rates begin to rise you will be able to "walk up yields" in your portfolio and improve your total return picture.



David W. Pequet, 57, founded the advisory firm MPI Investment Management, Inc. in 1986. MPI manages over 250 million dollars of primarily fixed income institutional and high net worth portfolios in the United States and in Europe. During the last two decades MPI has been nationally recognized several times for its fixed income investment management. Prior to starting MPI Mr. Pequet specialized in fixed income at several Wall Street securities firms including Prudential-Bache and Mosley Securities. He earned his Engineering degree from Michigan State University in 1974. Following college Mr. Pequet was in the Naval Aviation Officer Flight Program. For the last 25 years Mr. Pequet has been active at the executive level in several community and youth programs in the Hinsdale Illinois area, including 8 years as a board member of the Oak Brook Plan Commission, 6 years as coach and Director of the Hinsdale Little League, and has been a Director and Treasurer of the Hinsdale Public Library Foundation for the last 7 years. Mr. Pequet has been active for 25 years with the Roger B. Chaffee Scholarship Fund in Grand Rapids Michigan as both a Director and Treasurer. David is a member of The Bond Club of Chicago. In recent years he has been quoted and interviewed by Chicago Crain's Business Magazine, Investment News and The Wall Street Transcript. Mr. Pequet has been married to Christine since 1976 and they have two sons both in the investment business.

MPI Investment Management Inc., www.mpi-invest.com 800-237-0930

The information and data contained herein has been obtained from sources believed reliable, but in no way is guaranteed by MPI Investment Management, Inc. as to its accuracy. Market statistical information was taken from a broad list of sources including; The Wall Street Journal, Barron's, Standard & Poor's, Morningstar and Lipper Thomson Reuters. This is not a solicitation to invest in MPI Investment Advisory Services. MPI advisor services may or may not meet your investment goals and any consideration of such services should be discussed with your broker, attorney, accountant or other professional consultant. Statistical data is obtained from composites representing all accounts managed under each style. This information must be accompanied by MPI Investment Management, Inc's Part II Form ADV, which may be obtained on MPI's website, www.mpi-invest.com. For more information regarding information contained herein, phone 630 325-6900, or write us at 15 Salt Creek Lane, Suite 404, Hinsdale, Illinois 60521.