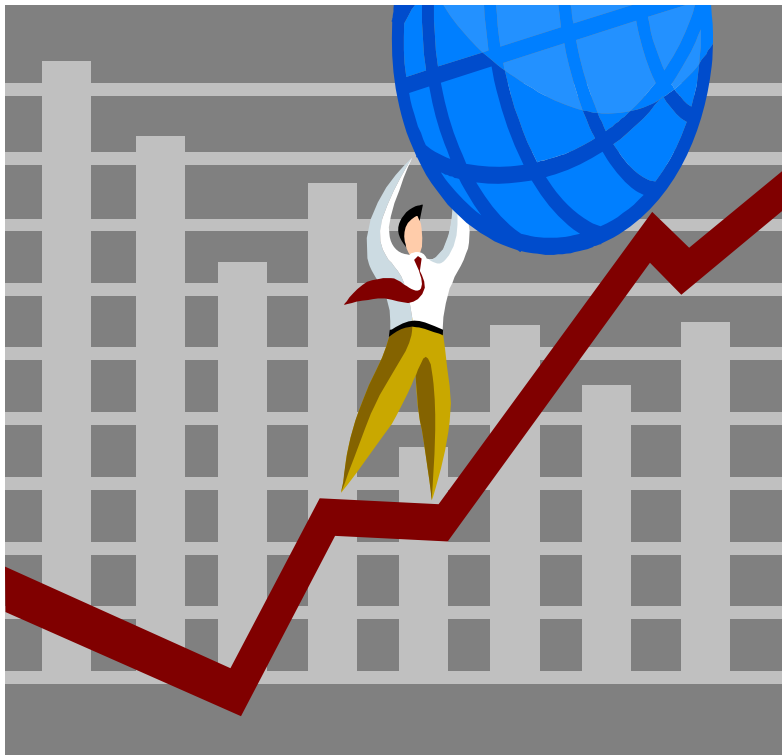


# The Next Hurdle

## 2009 Q4 Quarterly Commentary



**Robert W. Henkel**  
Chief Investment Officer  
[bhenkel@weyland.com](mailto:bhenkel@weyland.com)

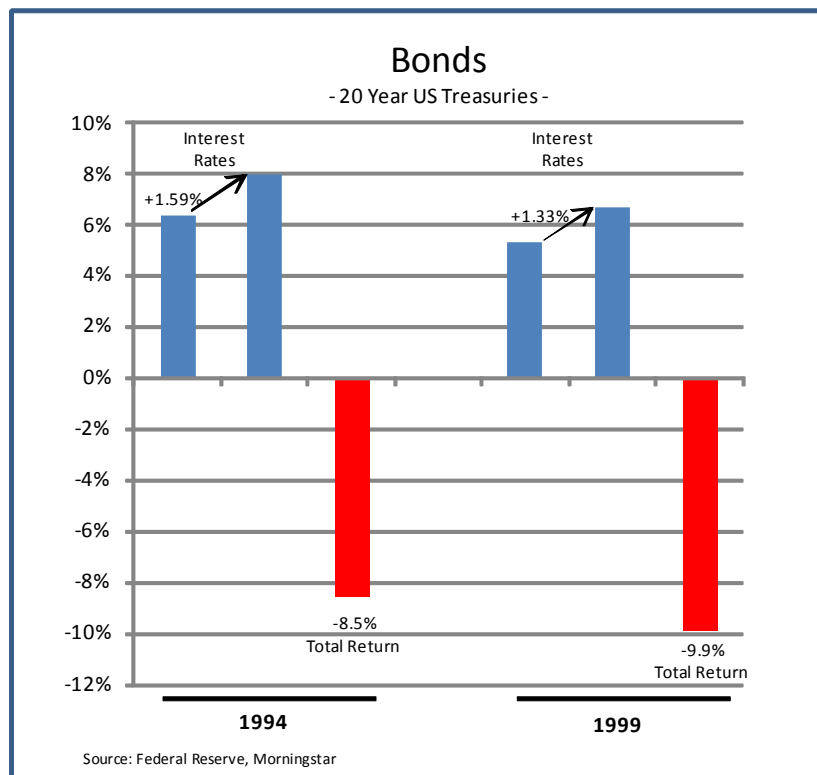
## The Next Hurdle

Capital markets threw a real “Hail Mary” pass in 2009. Stock investors were hoping that good times were ahead, with a return to a more normal economic environment. They boosted the S&P 500 by an astonishing 68% from March 9th through the end of the year. But sometimes investors can get ahead of themselves. What stock markets really want to see is the real economy actually “catch” that pass by growing at a reasonable rate.

Growth in the real economy this year would be a good thing, of course, with strong growth even better. But good news almost always carries challenging side effects along with it. That’s what this commentary will explore.

As you know, the Federal Reserve has brought down and kept the Fed Funds rate at historically low levels in order to encourage growth, as well as to help banks repair their balance sheets. But with re-emerging growth, the Fed will need to begin raising these short-term interest rates. And when growth re-emerges, investors will move to take on more risk and demand greater return. As a result, interest rates for intermediate and long-term bonds are likely to go up as these bonds compete with other investments for capital. And bond prices will go down.

Just as what happened in the past two bear markets for bonds in 1994 and 1999, the problem for bond investors is to find some place to hide while interest rates go up. The chart below shows how the rise in interest rates decreased the total return (interest + change in bond price) on long-term 20-Year US Treasuries in those two years:



But before discussing where those hideouts are, let’s review basic bond math.

Bonds are complicated investments because they are highly mathematical and counter-intuitive. One concept that many investors fail to appreciate is that when interest rates go up, bond values actually go down. Seems like it should be the other way around, right?

The best way, I think, to peel this onion is by example. Keep in mind that this example uses massive, unrealistic swings in interest rates to make the point and is in no way a prediction of future interest rates.

Imagine a 30-year bond for which you paid \$1,000 has a 5% coupon. That means for 30 years you will be paid \$50 interest annually, and at the end of the 30 years you will get back your \$1,000. If market interest rates remain unchanged at 5%, then the price of the bond remains at \$1,000. But what happens if inflation goes up? This will mean investors will want higher interest rates to compensate them for inflation.

Let's say that inflation pushes the market interest rates on 30-year bonds up to 10%. What happens to your bond? Is it worth more or less? It's still paying its \$50 per year in interest. But if other bonds are paying the going rate of 10%, the value of your bond has been cut in half. That's because for your bond to return the new interest rate of 10% with its \$50 interest, it can be worth only \$500 (\$500 times 10% equals \$50). It's only worth \$500 because other bonds are returning 10%, and the only way for your bond to adjust is by lowering its value. Remember, the only thing on a bond that is static is the interest in dollars it pays annually and the return of principal at the end of its term.

This is a simplistic example, but the bottom line remains: when interest rates go up, bond prices go down. And when interest rates go down, bond prices go up.

The measurement that captures the relationship between a change in interest rate and its impact on bond pricing is called duration, and it is a close cousin to a bond's maturity. Basically, the longer a bond's duration (or maturity), the bigger the impact an interest rate change has on its price. For example, if instead of holding a 30-year bond, one is holding a two-year bond, the price decline would be only about \$85 instead of \$500.

A bond with high duration (or long maturity) is a great investment when interest rates are going down, but toxic when interest rates go up.

I want to point out one more subtlety of duration that can impact bond pricing. Duration is much higher on bonds that pay low interest rates. Say you hold two bonds, one a 30-year U.S. Treasury paying 5% per year (like the one described above) and the other a "junky" 30-year corporate bond paying 10% per year. If interest rates on both bonds go up 5 percentage points, (to 10% and 15% respectively), the U.S. Treasury bond will go down about \$500 as noted above. But the junky corporate would go down only about \$330. In large part this is because the increase in interest rates is smaller on a relative basis for the corporate bond than it is for the Treasury.

Therefore, on balance, if you believe that interest rates are heading up, an effective strategy is to reduce maturity by buying short-term to intermediate-term bonds and avoid long-term bonds. And if there is no credit crisis, you can get additional benefit by buying bonds of lesser quality whose interest rates are higher.

That's what we've done for our portfolios this year: our current holdings emphasize corporate bonds of shorter maturity.

**Bob Henkel**  
Chief Investment Officer

# Disclaimer

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