

QUICK MARKET UPDATE

Rolling Down the Yield Curve—The Gift that Keeps on Giving

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In March 2010, we published a Quick Market Update “Rolling Down the Yield Curve—A Strategy to Challenge Money Market Yields” that discussed a strategy of investing along the steep short yield curve to capture higher interest rates and benefit from the so-called “roll down effect” as the bonds moved toward maturity. We asserted that strategy was sound given our expressed view at the time that money market rates would not likely increase in the near future, as the Federal Reserve Open Market Committee (FOMC) was not expected to raise its Federal Funds (Fed Funds) target rate. Since that time, the Treasury yield curve has continued to flatten.

Certainly, some investors might lament the missed opportunity to have earned yields greater than money market rates without taking on a great deal more risk to their total investment. However, we believe that the FOMC’s recent announcement to keep the target Fed Funds rate unchanged over the next two years can be considered another “gift” for investors to roll down the yield curve. This is especially true in the corporate-bond sector where the yield curve has remained relatively steep over the past eighteen months, even becoming significantly steeper the last few weeks with credit spreads widening in the Bank and Finance sectors.

In this Quick Market Update, we revisit our original example from last year and recalculate potential returns based on today’s interest rate levels.

Rolling Down the Yield Curve Explained

In an environment filled with so many uncertainties, there is one certainty provided by the bond market that investors, particularly those who are seeking income or have liquidity needs can use to their advantage—with the passage of time, a bond gets closer to its maturity. With that fundamental premise in mind, rolling down the yield curve simply means that an investor purchases a bond whose maturity is at the top of a steep portion of the yield curve and holds that bond until, over time, its maturity reaches a lower-yielding portion of the curve. In doing so, the investor enjoys the relatively high yield of that bond vs. the lower yields at the shorter end of the curve. Further, if done with short- or intermediate-term bonds, yield curve roll may provide protection against the risk of price decline, should interest rates move higher because:

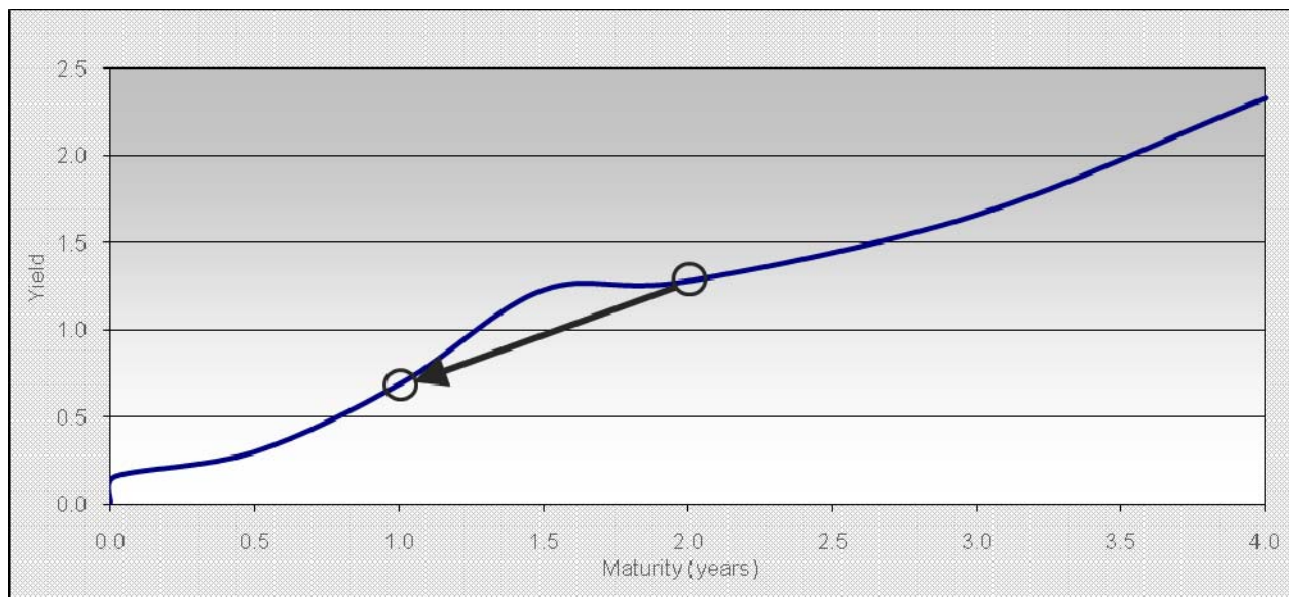
1. The bond’s duration (i.e. its price sensitivity to interest rate changes) is relatively short from the outset and

2. Some “cushion” for the value of the bond is built in as it transitions toward being priced off the lower yields on the shorter end of the yield curve with the passage of time.

Yield Curve Roll Down—Our Example Revisited

Today, three-year investment-grade corporate bonds now yield substantially less (1.66 percent vs. 2.28 percent in March 2010), while yields on two-year bonds are only slightly lower (1.28 percent vs. 1.45 percent). The differences between the scenario outcomes today compared to those eighteen months ago are not only lower yields, but also that the curve has changed its shape. Specifically, the corporate yield curve is less steep between three and two years, but more steep between two years and one year, than it was 18 months ago. Therefore, in the current yield curve environment, some investors would be wise to consider investing in a two-year maturity bond with the prospects that in one year’s time that bond could have a greater total return relative to other one-year bonds or money market. See chart below.

Chart 1: Corporate Bond (Investment-Grade) Yield Curve



Source: Bloomberg 9/12/11

In the table on the next page, we present several hypothetical scenarios of what the investor’s total return would be for that one-year period under various adverse interest-rate changes.

Table 1: Bond Roll Strategy Scenarios

Bond - Today						
Coupon	1.24%					
Maturity	18 months					
Price	100					
Total Value	\$100,000					
One Year From Today						
Interest Rate	Unchanged	+ ½%	+1%	+ 1½%	+2%	
Yield	0.30%	0.80%	1.30%	1.80%	2.30%	
Bond Price	100.47	100.22	99.97	99.72	99.48	
Interest Earned	\$1,240	\$1,240	\$1,240	\$1,240	\$1,240	
Principal Value	<u>\$100,470</u>	<u>\$100,220</u>	<u>\$99,970</u>	<u>\$99,720</u>	<u>\$99,480</u>	
Total Value	\$101,710	\$101,460	\$101,210	\$100,960	\$100,720	
Total 1 Yr Return	1.71%	1.46%	1.21%	0.96%	0.72%	
Scenario	Rolls down to six month yield	Roll completely offsets yield increase	Roll offsets almost all of yield increase	Roll partially offsets yield increase	Roll partially offsets yield increase	

* This chart is for informational purposes only. Example is hypothetical and the costs of transactions are not included.

As the table above illustrates, this yield curve roll strategy earns a much better total return over the subsequent year than can be achieved with money market yields in most interest-rate scenarios. Further, even when rates rose 1.5 percent in the example, the total value of the investor's account would still have appreciated. That results in a much more enticing set of opportunities than the approximate one-sixteenth of one percent per annum available in most money markets these days.

Investor Action Item

What are yield-starved investors to do? First, in pursuing a money-market-only approach, we believe that too many fear-struck investors are mistakenly choosing a strategy that is miscalibrated with their long-term goals. For investors facing this dilemma, the most important thing to do is to discuss your individual circumstances (goals, risk temperament, time horizon, etc.) with your investment professional. With that caveat in mind, if investors are seeking potentially more generous returns than are presently available in the money markets, we suggest they consider pursuing an active bond management strategy of rolling down the yield curve. Because such a bond-roll strategy requires in-depth yield curve and credit analysis, it generally requires professional guidance. An active bond manager can offer prudent implementation of an appropriate investment strategy that aligns with your individual investment goals, time horizon and risk tolerance. If you are interested in learning more about

a bond-roll strategy and how it may assist in pursuing your investment objectives, we encourage you to talk with your investment professional.

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