ALL BONDS ARE *NOT* CREATED EQUAL DURING RISING RATES

by Matthew Pasts, CMT, Chief Executive Officer, BTS Asset Management, Inc.

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One of the first things that any investor learns about bonds is their inverse relationship with interest rates. When interest rates rise, bond prices fall. While this may be a good rule of thumb, it doesn't consider the diverse universe of fixed income investments. Bonds vary by several key characteristics, including the type of issuer, credit quality, length to maturity, coupon rate, and risk factors. All of these factors play a role in determining just how much, and in what direction, a change of interest rates will affect a bond's price. With this in mind, it is clear that a one-size-fits-all approach to fixed income investing fails to capture the true impact of rising interest rates on a portfolio.

The majority of the U.S. bond market is made up of highly rated bonds such as Treasuries and Investment-Grade Corporate Bonds. For these bonds, it is true that interest rate changes are the primary factor affecting values. When an investor is confident that they will receive their principal and interest payments, their main concern becomes the yield of the bond. And when interest rates rise, new bond issues will come with higher yields. Thus, the old, lower-yielding bond becomes less attractive and will trade at a lower price. This phenomenon is known as interest rate risk. But what about a bond where the investor is not so sure that the issuer will be able to service its debt payments? This is called default risk, and for certain types of fixed income investments, default risk tends to dominate interest rate risk as the primary determinant of price movements.

Bond Sector Risks

Bond Sector	Default Risk	Interest Rate Risk
U.S. High Yield	High	Low
U.S. Long Term Treasury	None	High
U.S. Investment Grade Corporate	Low	High

There are three fixed income sectors in particular that tend to experience positive total return in a rising rate environment: high yield bonds, senior loans, and convertible bonds. Let's take a closer look at each of these sectors and the reasons why they may benefit from an increase in interest rates.

High Yield Bonds

High yield bonds, or junk bonds, are those with credit ratings below BBB according to Standard & Poor's. To compensate for this higher default risk, investors will receive a higher coupon rate on these bonds than they would on a similar investment-grade bond. Furthermore, high-yield companies generally issue bonds with shorter maturities than their higher-quality competitors. Higher coupons and lower maturities both lead to lower duration, which is a measure of a bond's sensitivity to interest rates. So just based on the terms of the bond, high-yield investors will face less downward price movement from a rise in rates.

Additionally, there are several aspects of high yield bonds that make a rising rate environment advantageous. From an economic standpoint, rates tend to rise in periods of expansion. With an expanding economy, most companies will generate increased profits, thereby increasing their ability to service their debts. This leads to a reduction in default rates which then creates upward price pressure on high yield bonds.

The vast majority of high yield bonds are callable, meaning that the issuer can redeem the bond prior to maturity. When a rate hike is expected, companies often try to take advantage of lower rates by refinancing their debt. When an issuer refinances its debt before maturity, they must typically pay a pre-payment penalty, which is added to the total return of the bond.

Reinvestment of coupon payments can be another benefit to high-yield bond holders in a rising rate environment. When an investor receives their coupon payment, they can reinvest it in the market at the new higher prevailing rates. With their higher coupon rates, this reinvestment opportunity is more beneficial for a high yield bond than it would be for an investment-grade bond.

Senior Loans

Senior loans are loans that banks make to corporations and then package and sell to investors. The reason that they are referred to as "senior" is because they are at the top of a company's capital structure, meaning that if the company were to fail, investors in senior loans are the first to be repaid. The loans are also secured by company

assets.

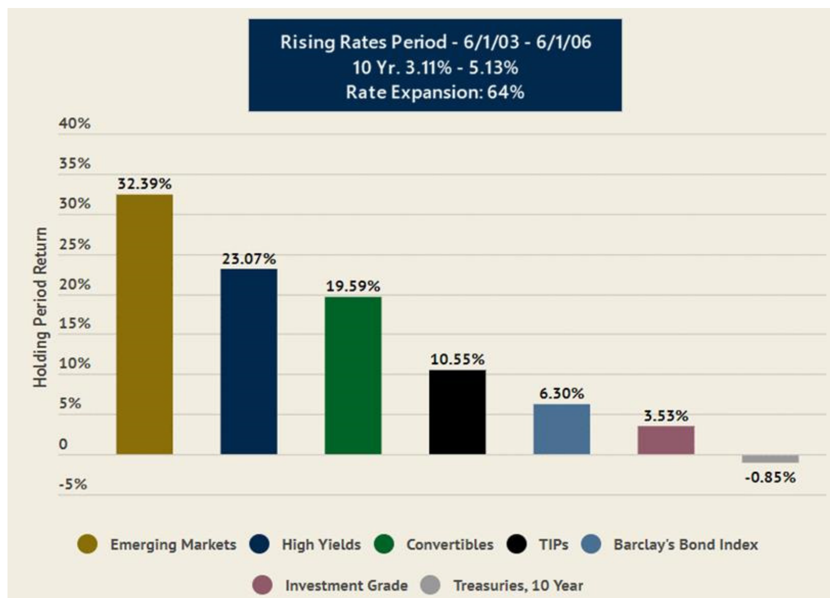
The combination of senior standing and securitization makes senior loans slightly less risky than a high-yield bond. However, the companies that tend to take out senior loans are those with ratings below investment grade, making them substantially riskier than an investment-grade bond. The net result is that senior loans pay a higher coupon than an investment grade bond, thus reducing their interest-rate risk in many of the same ways that high-yield bonds do, namely a reduction in duration, an increase in reinvestment opportunity, and an increase in the ability of companies to service their debt.

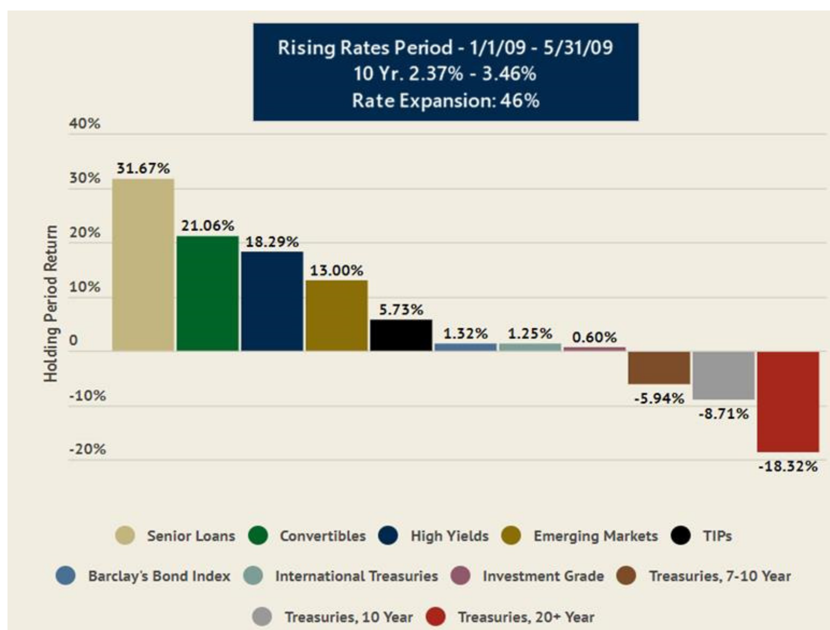
Another compelling aspect of senior loans in a rising rate environment is that they have floating rates that adjust higher as market interest rates increase. This benefits investors by providing an element of protection against rising interest rates.

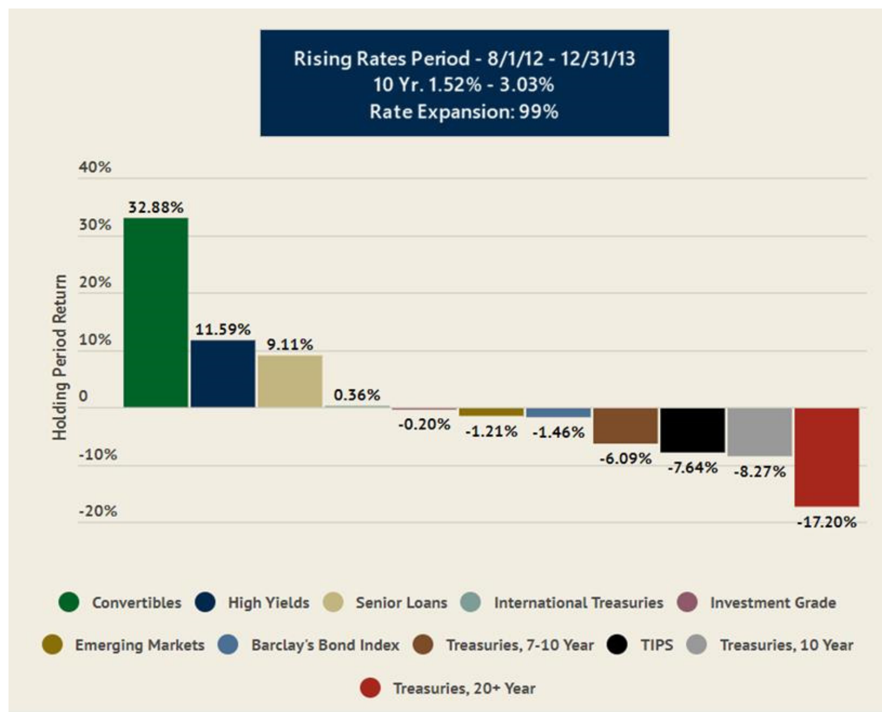
Convertible Bonds

Convertible bonds are corporate bonds that can be converted into a fixed number of shares of common stock. This unique “hybrid” structure combines equity and bond features, giving investors the best of both worlds. Like a plain vanilla bond, convertibles provide regular coupon payments and stated maturities. However, like an equity, convertibles also provide an increased potential for price appreciation, giving them a higher correlation to the stock market and allowing them to perform well in a rising rate environment during an economic expansion.

Another benefit of convertibles in a rising rate environment has to do with the companies that tend to issue them. Many convertibles are issued by companies in traditionally growth-oriented sectors such as technology, which have historically outperformed during periods of economic expansion, when interest rates are most likely to rise.







What Does This Mean for Investors?

With the potential for rates to rise, many investors may be impelled to stay away from fixed income. But bonds have traditionally been an important piece of a diversified portfolio, and it could be a big mistake to stray from the stability and income that they can provide. Rather than avoiding fixed income, investors should embrace the various sectors of the bond market that have historically bucked the trend of “rising rates, falling bond prices.”

Disclosures

Barclay's Bond Index - The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

High Yields – iBoxx USD Liquid High Yield Index measures the USD denominated, sub-investment grade, corporate bond market. The index includes bonds with minimum 1 years to maturity, minimum amount outstanding of USD 400 mil. Bond type includes fixed-coupon, step-up, bonds with sinking funds, medium term notes, callable and putable bonds.

Treasuries, 7-10 year - The ICE U.S. Treasury 7-10 Year Bond Index is part of a series of indices intended to assess U.S. Treasury issued debt. Only U.S. dollar denominated, fixed rate securities with minimum term to maturity greater than seven years and less than or equal to ten years are included.

Treasuries, 10 year – FTSE 10-Year Treasury Benchmark On-the-Run.

Treasuries, 20+ year - The ICE U.S. Treasury 20+ Years Bond Index is part of a series of indices intended to assess U.S. Treasury issued debt. Only U.S. dollar denominated, fixed rate securities with minimum term to maturity greater than twenty years are included.

Emerging Markets – The J. Morgan EMBI Global Core Index is composed of U.S. dollar-denominated, government bonds issued by emerging market countries. The index is a broad, diverse U.S. dollar denominated emerging markets debt benchmark that tracks the total return of actively traded external debt instruments in emerging market countries. The methodology is designed to distribute the weight of each country within the Underlying Index by limiting the weights of countries with higher debt outstanding and reallocating this excess to countries with lower debt outstanding.

Investment Grade - The U.S. Corporate Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

TIPS - The Bloomberg Barclays US Treasury Inflation-Linked Bond Index measures the performance of the US Treasury Inflation Protected Securities (TIPS) market. Federal Reserve holdings of US TIPS are not index eligible and are excluded from the face amount outstanding of each bond in the index.

Convertibles – The Bloomberg Barclays U.S. Convertibles Liquid Bond Index tracks United States convertible bonds with outstanding issue sizes greater than $500 million. Convertible bonds are bonds that can be exchanged, at the option of the

holder, for a specific number of shares of the issuer's preferred stock ("Preferred Securities") or common stock.

International Treasuries - The Bloomberg Barclays Global Treasury ex US RIC Capped Index tracks fixed-rate, local currency government debt of investment grade countries (ex US), including developed and emerging markets. The index is a customized subset of the Global Treasury ex US Index with the same diversification guidelines that a fund must pass to qualify as a regulated investment company (RIC).

Senior Loans – The Markit iBoxx USD Liquid Leveraged Loan Index is comprised of about 100 of the most liquid, tradable leveraged loans, as identified by Markit's Loans Liquidity service.

Each of these asset classes has its own set of investment characteristics and risk and investors should consider these risks carefully prior to making any investment decisions.

Past performance is no guarantee of future results. Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

The value of the fixed income securities will fluctuate with changes in interest rates. Defaults by fixed income issuers could also harm performance. Lower-quality bonds known as "high yield" or "junk" bonds, present greater risk than bonds of higher quality, including an increased risk of default. An economic downturn or period of rising interest rates could adversely affect the market for these bonds.

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