April 2013

About Beacon Financial Advisors Ltd.
Beacon is an independent fee-only advisor with a clear mission statement: To provide our clients long-term value-added financial counsel and investment performance with *exceptional service.*
Beacon is a Registered Investment Advisor with the US Securities and Exchange Commission.

Beacon's Advisors
MARCEL HEBERT has a B.S. in Finance, an M.B.A., and is a Certified Financial Planner (CFP) licensee and a Chartered Financial Analyst (CFA) charterholder.

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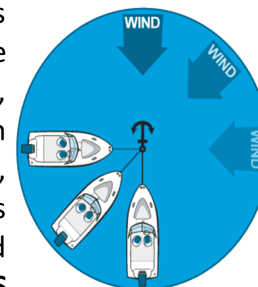
CHARTING THE COURSE

Special Series of Briefs About Beacon's Client Services

BONDS: Anchor in Your Portfolio...*But Watch Those Interest Rates!*

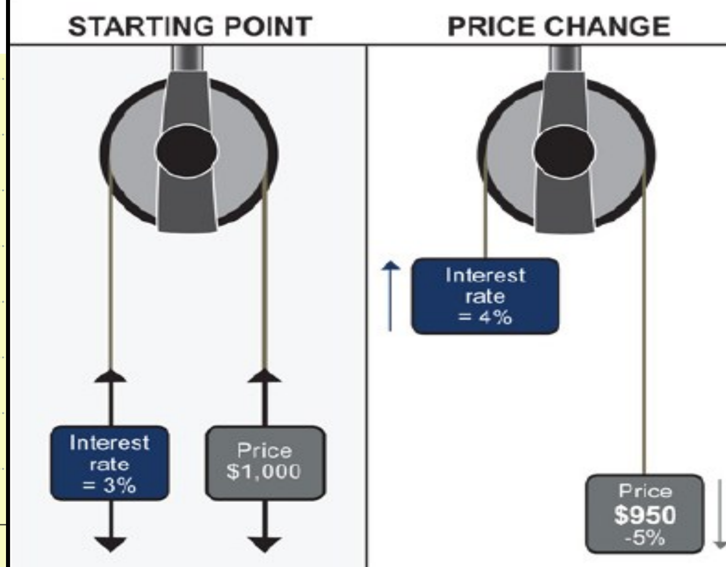
Anchor to windward! **BEACON** likes to borrow that nautical term when we address clients about the key role of bonds (aka fixed income) in a balanced, global portfolio. We want bonds to give our clients income and a total return north of cash, maintain a high degree of liquidity, and preserve capital. This last objective, capital preservation, describes the "anchor to windward", as when bonds provide some protection in the client's overall portfolio when stock markets are misbehaving. So, even as we assert bonds are a core asset class in a diversified portfolio, it is vital to understand how bonds behave in differing market environments especially as interest rates change. We will establish that bond prices move opposite the direction of interest rates (charts below). Then we will consider **BEACON'S** outlook for interest rates and how that perspective impacts our bond strategy to minimize interest-rate risk.



(continued p.2)

BOND PRICES move opposite INTEREST RATES

BOND PRICE drops as INTEREST RATE rises



BONDS: Anchor in Your Portfolio...*But Watch Those Interest Rates!*

Now we understand the price (value) of bonds rise if interest rates fall, or fall if interest rates rise. We then need to understand the current level of interest rates relative to history (see charts below). We then must have an informed view of the likely direction of future rates *and* the expected magnitude of the change in rates (see page 3). The major "takeaway" from the two charts below is that US interest rates now stand at an historic low. The "great recession" of 2007-2009 resulted in massive monetary initiatives by the US Federal Reserve ("FED") to halt the economic decline and to stimulate an economic recovery. The FED has anchored a key interest rate at 0%, and nominal interest rates are the lowest in generations (real rates after inflation are negative). The southwest chart shows the dimensions of short, intermediate, and long government interest rates including a hi/low range (orange bars), a mean/average (white lines), and the current level of those rates (black lines). The southeast chart shows how short and long term government rates have changed through time. The post-WWII economic expansion, led by a housing construction boom, caused interest rates to rise in the 1950-1970 period. The "oil shocks" of the 1970's, in part, caused a dramatic spike in interest rates in that decade. In the 1980's to the present, US interest rates have declined steadily and given bond investors a long-run bull market. But, with interest rates resting near the floor investors face the possibility of rising rates in the future—and price declines for bonds. Next up, our outlook.

US INTEREST RATES REST NEAR THE FLOOR

History of Interest Rates
July 1954–December 2012

20%
15
10
5
0
Average: 5.32%
Current
5.92%
6.47%
5.25%
1-yr government yield
IT government yield
LT government yield
Federal funds

RISING RATES UP NEXT? HOW BEST TO NAVIGATE?

Bond Yields During Recessions
1946–2012

18% Yield
16
14
12
10
8
6
4
2
0
• Short-term govt bonds (4/53–12/12)
• Long-term govt bonds
Shaded regions denote economic recessions
2.41%
0.16%
1946
1956
1966
1976
1986
1996
2006

BONDS: Anchor in Your Portfolio...*But Watch Those Interest Rates!*

The widespread investor panic in 2008 resulted in over $1 trillion of net flows into bond mutual funds (out of stocks). On that rising tide of investor demand, coupled with the FED's "anchoring" of short rates, bond yields have plummeted (see page 2). A "bond bubble about to burst" is how some have described the losses bond investors could sustain if we had a quick uptick in interest rates—investors will flee bonds, they predict. **Beacon** thinks there is time to navigate this bond market, and we believe our active, talented bond managers have the right strategies if rates rise. We do think interest rates will rise, but we think *several things have to happen first* and these can be evaluated and anticipated.

1. **The economy would have to improve drastically**— If US interest rates rise in the next year or three, it will likely be because the economy is growing faster—much faster than today's 1%-2% annual growth. While there are positives like the rebound in housing, the improving balance sheets of consumers, and the great health of corporate America, it still seems like the US political parties are miles away from enacting sound fiscal policy. Europe is still a global laggard.
2. **Don't fight the FED**— The FED has signaled it will not abandon it's 0% federal funds rate until unemployment falls to 6.5% (from 7.7% now), and core inflation is no greater than about 2.5%. We are not anywhere close to the FED's unemployment target, and that slack in the labor market is not pressuring inflation.
3. **No one wants what you're selling**—by this we mean demand for US debt would have to fall. There is still ample evidence that the US's major trading partners are still increasing their holdings of US Treasuries. Most of these trading partners are more concerned with collateralizing their trading positions in our local currency, and are less sensitive to interest rates.
4. **US as "safe haven" replaced by _______?** - " the least bad house in the neighborhood" is how some contrast the US (our large sovereign debt, $ trillion budget deficits, etc) with our global trading partners. However, despite this problem, in times of turmoil global investors still take-flight to US Treasuries. If we can make more progress on the fiscal front (i.e. reduce spending et al), our safe haven status will be strengthened. Besides, where else will investors go? Cyprus? The US is still *the* safe haven, and that demand for our sovereign debt keeps downward pressure on US interest rates.

Next, we think rising interest rates are not necessarily bad provided rates don't rise faster or higher than the bond community anticipates. As we suggested above, and often overlooked, is that if interest rates are rising then the economy is probably stronger. For the US economy, a better economy would mean tax receipts are rising faster as well. So, an increase in interest costs on the national debt could be offset by increased revenues. As for our clients, rising interest rates in an improving economy has benefits as well. For one, stock prices would have added support as corporations improve earnings. But, specifically for our fixed income investments **Beacon's** active managers at AllianceBernstein, Dodge & Cox, Fidelity, and TCW/MetWest can take the sales proceeds from maturing (or pre-matured & sold) bonds and reinvest in new bonds at the higher interest rate. The chart on the right shows how this increased income helps offset a decline in price. Stay tuned!