



Economic Commentary - 1st Quarter 2003

A Strategy for Rising Rates

Sometimes the most difficult – and important – thing an investor can do is sit and wait for the markets to react to their myriad of influencing factors and to offer value to the investor. At turning points in rates and trends, even an actively managed portfolio must evaluate this alternative on the basis of its fundamental objectives.

When fixed income market rates are turning down, as they were in early 2001, it is imperative to identify upcoming liabilities and fund those liabilities thereby locking in yields that will hold as short-term and over-night rates drop. When rates have reached what is perceived as the bottom – or have nowhere else to go as is the case currently at 1.25% on the federal funds rate – it is as imperative to protect a portfolio's liquidity in order to ride the rates up and buy at a more reasonable level. Moving too quickly can lock a portfolio into low rates which will not provide on-going value as rates rise.

Currently, the fixed income markets are at historically low levels. When rates go up history shows us that they do so quickly. The chart below shows four periods in recent financial history. The quick retracement of rates is due in large part to the fact that (a) money will flow to where it is treated best and (b) market participants are always attempting to move into the trend at its start in order to gain value. Much of the current low rate scenario is due to money which has flowed out of the equity markets. As soon as those markets begin to trend upward money will be immediately drawn out of the fixed income markets and money market funds raising rates. The volume of the money in these short terms, money market securities is a good indication of the potential flood out of fixed income and into equities – even with some lingering trepidation about equities themselves. As such, we would expect the rates to increase very quickly.

Historical Increasing Rate Scenarios (2 Yr)			
From - To	Time Elapsed	Rate Change	Amt.
12/86 – 02/88	14 mos.	6.3 – 9.1%	2.80%
09/93 – 12/94	15 mos.	3.9 – 7.69%	3.79%
12/98 – 12/99	12 mos.	4.5 – 6.3%	1.80%
09/99 – 03/00	6 mos.	4.3 – 6.6%	2.30%

These findings indicate that in the last four rate increase scenarios the two-year Treasury Note rose an average of 2.79% in just twelve months. If that scenario were to be replicated now, the current two year would rise from 1.50% to 4.29% by April 2004. **Locking into the lower rate as rates begin to turn and rise places the portfolio below market values for a long period of time.** Locking in now to a 1.50% would potentially put the portfolio 300 basis points (3%) below market value in just one year.

In addition, the two year, and indeed the entire short end will probably move more quickly because of a change in the yield curve which occurred in March 2001. At that time the Treasury eliminated the one year Treasury Bill because of the then-current budget surplus. With the current growing deficit, the Treasury will probably be forced to re-initiate the one-year. When and if this occurs the supply in this sector will increase bringing prices down and raising rates quickly. Reinitializing the one year Bill should have the tendency to also pull up the two year and six-month portions of the curve. If this coincides with other fundamentals the rate increase could be quite dramatic.

The timing on the turn and the move in funds from fixed income to equities is dependent upon the many factors currently battering the markets. The primary factor is the Iraqi campaign. The underlying factor is the economy. As the Iraqi situation becomes clearer and a post-war timeline weakly drawn, then the markets can focus on underlying economic fundamentals. (Even the Federal Reserve's FOMC committee refused to announce its bias at its February meeting because of the distortion of the war.) The confidence fluctuations driven by the war have already given clear indication of their impact. In the first few days of the conflict every positive and every battlefield victory results in impressive gains in the Dow and higher interest rates. The numbers below trace big gain days from March 19, 2003 through the end of March.

Dow versus Treasury Movements – Iraqi Conflict Impact

<u>Dow Increase</u>	<u>2 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>
300	.24%	.20%	.19%
300	.20%	.14%	.29%
200	.15%	.15%	.16%
<i>Approx. average move per 100 pts:</i>	<i>.08%</i>	<i>.06%</i>	<i>.08%</i>

With the Dow hovering around 8,000, and assuming a relatively easy return to the 10,000 area in at least one year, **these statistics indicate that the 2 year would move approximately from a 1.5% to 3.1% and the three year area from 2.0% to 3.20%**. Any fraction of this type of move would place securities bought at the current levels in an unrealized loss position and because of that unrealized principal loss eliminate liquidity for the duration of the bond. The liquidity loss is not just a loss of operational flexibility but the loss of taking advantage of rates as they rise. This is a true opportunity cost to the portfolio.

The yield curve is clearly indicating that it is ready to move upward on participants' expectations of the future of rates as conditions in Iraq and economic conditions improve. During this period it is significantly important to stay short – perhaps out to the 9 month area – to hedge potential further short-term downward moves, but, not to extend past that 9 month area. **The portfolio will form a moving ladder which climbs up the rates as bonds mature and are reinvested at higher rates.**

It is very tempting in periods of low interest rates to stretch for yield (which by its nature requires maturity extension), but, by doing so the portfolio is put at considerable risk because of the larger loss which can – and will – be incurred.

In investigating alternatives we have to look at alternatives in the two current, prevalent rate scenarios, i.e. stable rates and rising rates and little chance of significant downward movement in rates. One can also look at a significantly lengthening the portfolio to the five year maturity range.

There is no question that, on a static evaluation basis, extensions in maturities will gain yield. You are being rewarded at that point in time for the risk you are taking. The extension for yield produces a static gain but will not overcome the on-going risk of loss of principal or liquidity or the opportunity costs incurred as rates rise. It is critical to always put portfolio decisions in a wider context than the one time trade or yield analysis. It is critical to take a portfolio perspective looking at rate trends, market expectations, and other influences.

By investing in the shorter maturities now and laddering out maturities to catch the rates as they rise the portfolio avoids the significant opportunity costs of a longer term choice. Assuming even a 25 basis point gradual curve rise over three years a ladder not extending beyond twelve months at any time and rolling with the rates might rise and earn at approximately the same yield as the current five year continuous callable securities (3.67%). A slightly accelerated pace in the same period returns a yield equivalent to the current 12 year maturity.

Summary

There are significant dangers in **chasing yield at these low rate levels**. As rates move and opportunities present themselves a portfolio of securities under twelve months can be created and rolled (as they mature) into increasingly higher yielding securities until sufficiently or stable rates at a higher level are attained. The timing is dependent on current short term rates. When pool and fund rates can be matched or beaten on the average yield you will achieve several goals:

1. **Protection from falling rates.**
2. **Advantage of the slightly higher yielding rates** but no longer than one year.
3. **Movement with upward rates** across a one year period instead of staying in the shortest end.
4. **Diversification.**
5. **Maintenance of a sufficient level of liquidity.**
6. **More yield over time than is now available in even the five year area without the risk.**
7. **No opportunity costs.**

The first fiduciary responsibility is safety but not at the expense of reasonable market yield. To achieve both requires a strategy which takes into account an overall portfolio perspective: not a static evaluation of current rates but a dynamic view of market forces and trends, potential effects and potential growth.