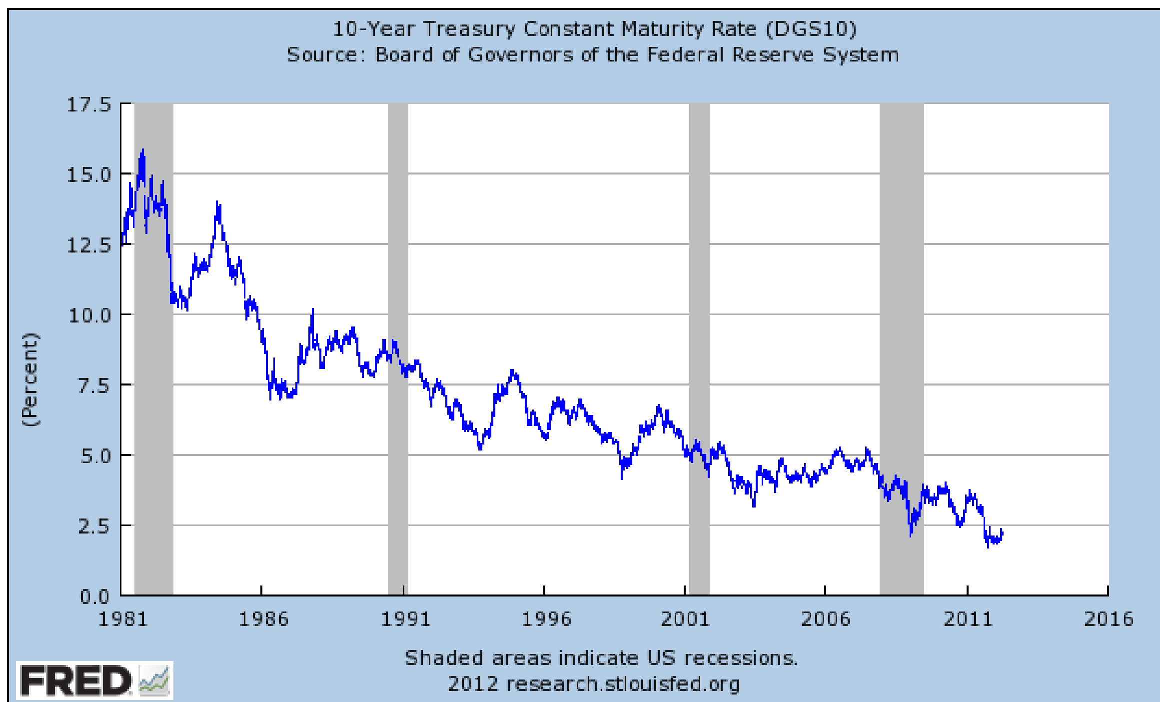
April 2012

INVESTMENT PERSPECTIVES

Bonds and Rising Interest Rates

In this Investment Perspectives we wish to address our laddered bond portfolio strategy and why it makes sense even in a rising interest rate environment. As most of you know, bond yields are near historic lows. For example, the 10-year U.S. Treasury note, a widely used benchmark had a yield to maturity of 2.21% at the end of the first quarter, just above its record low of 1.83% in September 2011.

In 1981, with 10 year Treasury yields at historic highs of almost 16%, they had more room to decline than at any other time. This scenario set the stage for what is generally considered the greatest bond bull market in history. The chart below shows the long-term historical trend in yields of the 10-year Treasury note since 1981, a year in which bond investors could have "locked in" rates of almost 16%.



In recent years, massive amounts of money have flowed out of stock mutual funds and into bond mutual funds. Despite solid stock market returns this year, enthusiasm for bond funds has not

diminished and 2012 could be the fourth consecutive year in which money flows into taxable bond funds outpace those for any other mutual fund category, according to Morningstar Direct. A primary reason for the attraction of bonds over stocks has been recent performance. Back in 2000 at the height of the tech and telecom bubble there was tremendous enthusiasm for stocks as an asset class (after the S&P 500 Index had produced 28% annualized returns for the prior five years from the beginning of 1995 through the end of 1999), while bonds were considered a "boring" asset class which offered little upside potential. The subsequent decade, however, turned out to be an excellent period for bond investors and one of the worst for stock investors. In the 2000-2009 decade, U.S. large company stocks as measured by the S&P 500 Index produced annualized returns of minus 0.09% while U.S. intermediate government bonds provided annualized returns of 6.2%[1].

What Are Bonds?

A bond is a loan that an investor makes to an issuer. The issuer (corporation or government) borrows a certain amount (principal) from the lender (investor) for a certain period of time at a fixed rate of interest (coupon rate). At the end of that period, the bond matures and the issuer (corporation or government) repays the lender (investor) the amount (principal) of the bond.

Investors typically hold bonds in their portfolios to generate income, protect themselves from economic uncertainty, and diversify their holdings. Bonds typically provide a more stable income stream compared to stocks because they pay a contractually fixed rate of interest. In addition, bonds are generally less volatile than stocks and offer a more predictable income stream during times of economic uncertainty. Bonds also provide important diversification benefits to a portfolio, because bonds often increase in value when stocks decline. In sum, bonds represent important portfolio "shock absorbers" that offer a cushion during periods of market turbulence. Bonds can also be a great way to raise cash without having to sell a stock that may have higher taxable consequences.

What is the Bond Market?

The bond market (also known as the credit, or fixed income market) is a financial market where participants can issue new debt, known as the primary market, or buy and sell debt securities, known as the secondary market. The primary goal of the bond market is to provide a mechanism of providing funds today for major capital needs that can be paid back over long periods of time. At the end of 2010, the size of the global bond market (total debt outstanding) was an estimated $95 trillion (compared to the global stock market of $55 trillion). The U.S. bond market debt outstanding was $35 trillion at the end of 2010.[2]

Current Outlook for Bonds

There seems to be a growing divide between two camps regarding the current outlook for the bond market. The first camp believes bonds will be a poor investment for the following reasons:

[1] 2011 Ibbotson SBBI Classic Yearbook
[2] TheCityUK, Bond Markets, July 2011

- Yields are at historic unsustainable lows. This camp believes there is growing evidence that an economic recovery is underway and this will be accompanied by higher interest rates as demand for money increases. (See Risk of Owning Bonds details below).
- They also are greatly concerned that the large excess liquidity and "cheap money" in the U.S. and globally will translate into higher inflation which will also cause interest rates to rise.

The second camp believes bonds are good investments at this time for the following reasons:

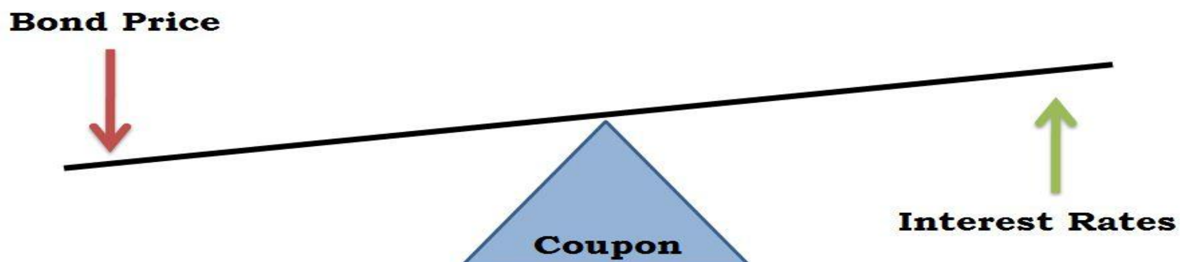
- After more than a decade of sub-par stock returns and unprecedented volatility in the past year, this group believes that bonds will be much more stable investments than stocks to own in the uncertain times that seem to be ahead of all of us.
- Bonds provide a reliable and incrementally higher yield than cash alternatives.
- Inflation is not a concern because they believe the economy will continue to "muddle" along at best and the pressures that tend to move inflation higher will not materialize.
- Since bonds have done well in the recent past, they will therefore do well in the future.

Risks of Owning Bonds

Bonds have three main risks – any one of these can have a detrimental effect on the principal value of a bond:

- Credit Risk: The potential for the issuer of a bond to go bankrupt or not be able to pay interest or return principal.

- Interest Rate Risk: As interest rates rise, the price of an existing bond decreases. For example, if an investor bought a $10,000 bond today at par with a 5% coupon, an investor would receive $500 per year. If rates rose to 10%, a new investor who bought a $10,000 bond would receive $1000 per year in interest. The original bond would drop in price to compensate a new investor for the increase in rates. If an investor sold a bond during this time, they would not get back their face value of $10,000. If they held the bond to maturity, however, they would get back their original investment of $10,000.



- Liquidity: The ability to find a buyer or seller for a bond.

At Hutchinson Capital, we look to garner all the benefits of owning bonds while minimizing the risks associated with them. First, we purchase only high quality bonds with investment grade ratings. When there is turmoil in the financial markets, high quality bonds tend to outperform

stocks. Second, we believe that a ladder is the best balance of risk and reward for interest rate risk. The ladder aims to purchase equal dollar amounts of bonds in successive years with a maximum maturity of ten years.

We believe that the ladder is a wise strategy in a rising interest rate environment. As bonds with lower interest rates mature at the low end of the ladder, they are replaced with higher yielding bonds at the end of the ladder. By following this strategy, a portfolio benefits as interest rates move higher. While the bonds an investor holds can lose value in the short-term due to higher interest rates, the investor will receive the face value if the bond is held to maturity.

Biggest Mistakes in Bonds

The biggest mistakes we have seen people make is "stretching" for yield and buying potentially illiquid bonds. Many people focus only on the yield of a bond – four or five percent in this yield environment all sounds very enticing! What people can lose sight of is that the principal amount they are investing in the bond, the thousands or hundreds of thousands of dollars, is many times greater than any interest they will receive over the life of the bond. They are risking a substantial amount of money to realize a relatively small amount of incremental gain.

For example, in the 2002-2008 periods, subprime mortgage bonds were considered to be attractive because they yielded 1/2 of 1% more than similarly rated AAA securities. Many institutions bought them extensively to enhance the yield in their portfolios. Unfortunately, when the housing market declined precipitously, the quality of these bonds deteriorated very quickly and became illiquid.

We specifically focus on buying bonds that have a history of liquidity in the marketplace. Typically, these are bonds issued in larger quantities that tend to attract more buyers and sellers. This gives us a better chance of selling bonds if the need arises.

Individual Bonds vs. Bond Funds

Why do we buy individual bonds versus bond funds? With a bond fund there is risk of loss of principal as rates rise. As a manager of a mutual fund has no directive to hold bonds to maturity, many of these managers will sell bonds as interest rates rise resulting in a realized loss of principal. We believe holding individual bonds to maturity in a laddered strategy tends to have less interest rate risk than owning a bond fund.

Individual bonds tend to be more tax efficient as well, as we are buying bonds that have the best "after tax" yield for a specific situation. We can also sell bonds that have a principal loss and reinvest those dollars into similar yielding bonds and use this loss to offset potential capital gains.

Another disadvantage of bond funds is that there may be embedded capital gains in the fund and a new investor would be liable for the taxes on these earnings even if they did not benefit from the gains.

Guessing the Direction of Interest Rates

At HCM, we do not guess whether interest rates are going up or down. While many forecasters will try to guess which way interest rates are heading, we have found that many have been wrong. There is a famous quote by noted economist John K. Galbraith: "There are two types of forecasters: those that don't know and those that don't know they don't know."

We believe that rising interest rates will only cause a temporary decline in bond prices; however, if the bonds are held to maturity, the initial yield to maturity will be realized. We actually look forward to higher interest rates as these will provide a ladder with additional yield and only a temporary decrease in the price of bonds that are held. Many investors have sat on the sidelines earning no interest waiting for rates to rise for weeks, months and now years. While we too believe that over time interest rates will rise, we do not pretend to know the timing and magnitude of this change. We will gladly invest in bonds earning a fair return while we strategically position the portfolio to take advantage of higher rates.

Conclusion

At Hutchinson Capital, we believe that high quality investment-grade bonds are essential for capital preservation even in a rising inflationary and interest rate environment. The future will deliver some unpleasant performance results occasionally; however, bonds will act as an important safety net because they can provide the stability that an all equity portfolio often will not. In addition the stream of income that bonds provide enhances returns if the principal is reinvested when a bond matures.

As we have stated many times, we strongly believe that one of our most important responsibilities to each of our clients is to preserve their capital and to strive to continuously achieve a compounding growth of this capital. In our opinion, owning a high quality bond portfolio will greatly minimize the downside risk in a portfolio over time and will significantly aid us in accomplishing our primary investment objective of consistently compounding returns while preserving capital.

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

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