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What About Fixed Income?

With all the recent lowering of interest rates by the Federal Reserve, and with money market yields below 2% it would seem that interest rates are about as low as they can get. This is a circumstance that gives us cause to examine the role of fixed income in our portfolios. Not just because yields are low, but also because it seems that the direction interest rates are likely to head next is up. And changes in interest rates have an immediate and certain effect on the value of bonds in the marketplace. Decreasing interest rates provide a "tailwind" by increasing the value of bonds, increasing interest rates provide a "headwind" by decreasing the value of bonds. So, why would anyone want to hold bonds knowing that interest rates are going to go up?

The first, simplest, and quite compelling answer is that we hold bonds in a portfolio for diversification and as a component of total return. Because we are "total return" investors, and not "income" or "yield" investors, we incorporate the relatively stable value of fixed income, along with the relatively consistent yield, to add stability to our portfolios of relatively volatile equity assets. And since we do not pretend to know which direction the interest rate market is headed next quarter or next year, we simply hold a mix of fixed income that suits our own risk profile for good years and bad. With this we get the required diversification, a reasonable yield, and a relatively stable store of value.

The second, and equally compelling answer is that interest rates, other than at the very short maturities are not particularly low. Compare the 2001 ending rates with the long term averages in the table below. Note that intermediate term treasuries (7 year) are quite near their long term average. Short term rates, (1 year or less) are indeed low, and with the 3-month Treasury yielding 1.72%. This would seem to imply that there is not much room left for the Fed to lower short term rates. However ….

Treasury Yield Rates and Changes

	1999 End	2000 Chg	2000 End	2001 Chg	2001 End	Long Term Avg
1 month	-	-	-	-	1.72	3.82
3 month	5.36	+0.58	5.94	-4.22	1.72	-
1 year	5.84	-0.14	5.60	-3.38	2.22	4.26
3 year	6.14	-0.88	5.26	-1.64	3.62	-
7 year	6.38	-1.10	5.28	-0.42	4.86	4.92
15 year interpolated	6.28	-1.04	5.24	-0.15	5.09	-
30 year	6.35		5.49		5.48	5.37

The final, (this is really my final, and perhaps the most compelling) answer is that we really do not "know" that interest rates are going to go up, and, equally importantly, how fast they will go up if they do. Notice the difference between the effects of the 1999 rate increases and the 1994 rate increases. In 1994 the rates rose more rapidly and the effects were concentrated. Moderate rises in rates are absorbed fairly readily, sharp increases are more troublesome. But if we could really predict future interest rates that reliably, accumulating great amounts of money would be, truly, child's play.

A review of the effects of the 1999 and 1994 interest rate hikes is described in the following tables.

1999 Rate changes by Mutual Fund Category

Fund Category	Treas. Proxy	Interest Rate Change	Fund Average Maturity	Total Return 1999	Decline in NAV
Ultra Short	2yr	+1.59	2.80	4.82	-0.48
Short	3yr	+1.66	3.00	2.53	-2.78
Intermediate	7yr	+1.73	8.20	-0.94	-6.46
Long	15yr	+1.63	13.30	-2.29	-8.04

1994 Rate changes by Mutual Fund Category

Fund Category	Treas. Proxy	Interest Rate Change	Fund Average Maturity	Total Return 1994	Decline in NAV
Ultra Short	2yr	+3.38	2.80	3.31	-2.59
Short	3yr	+3.17	3.00	-0.30	-6.43
Intermediate	7yr	+2.32	8.20	-3.63	-10.27
Long	15yr	+1.82	13.30	-5.19	-12.18

Notice that in the long maturities, a fairly small differential in rate change produces a fairly large differential in resulting decline in NAV (Net Asset Value). That's the main reason we stick with a blend of short-term and intermediate-term fixed income holdings.

Market Review

The 4th Quarter of 2001 was a welcome respite from the previous 18 months.

The table below shows the returns through December 31, 2001 for selected basic investment asset classes. In most cases, the results below are an appropriate benchmark for the related mutual funds in your investment portfolio.

Asset Class Performance

	Last 3 Months	Last 6 Months	Last 12 Months
U.S. IT Gvt TR	-0.76	5.26	7.62
LB IT Gvt/Credit TR	0.09	4.70	8.98
LB 20 Yr Muni TR	-0.53	2.25	4.83
Domestic Hi-Yld Corp TR	5.77	1.30	5.28
SB Non-U.S. 1+ Yr Gvt TR	-3.97	3.48	-3.54
S&P 500 TR	10.69	-5.56	-11.88
S&P/BARRA 500 Growth TR	13.02	-1.90	-12.73
S&P/BARRA 500 Value TR	7.96	-9.53	-11.71
U.S. Small Stk TR	21.26	0.04	22.77
Russell 2000 TR	21.09	-4.09	2.49
BGI Small Cap Growth TR	25.53	-5.83	-15.13
BGI Small Cap Value TR	23.97	6.67	18.50
NAREIT-Equity TR	4.98	2.23	13.93
MSCI EAFE TR	6.98	-7.95	-21.21
MSCI World ex U.S. TR	7.17	-7.81	-21.16
S&P/IFCG Emerging TR	24.88	-1.82	-0.29

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