Buy/Hold PLUS®

Rising Interest Rates: How are you prepared?

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PART 1: WHAT CAN BE DONE TO COMBAT RISING RATES?

Duration

No one knows when rates are going to rise, only that it is going to happen at some point in the future. Instead of asking when they will, the better question is: "What happens when rates do go up?". Conventional thinking often begins and ends with when rates rise, bonds go down in value, with those of longer durations (more years left) affected the most. This results in the most common combative technique, and the one that receives the most attention, of buying shorter term bonds. However, while certainly an important component, shortening duration is not by any means the only strategy in combating rising rates.

"Rates"

It is important to note that the common term of "rising rates" generally boils down to the fear of increasing U.S. Treasury rates – one category of bonds. Clearly, an increase in U.S. Treasury rates will adversely affect all fixed income sectors. However, there is no "pure" correlation between the U.S. Treasuries and other fixed income sectors. In other words, rising rates do not equate to a common loss across all debt securities. Figure 1 below depicts the potentially vast correlation spread between various fixed income sectors to illustrate this point.

"In other words, rising rates do not equate to a common loss across all debt securities."

Figure 1 *(5 Year Period Ending 3/31/13)*

	U.S. Treasuries	U.S. Agencies	U.S. MBS	Global Bonds	U.S. IG Corp	EM Debt
U.S. Treasuries	1.00	0.87	0.78	0.49	0.25	0.06
U.S. Agencies	0.87	1.00	0.84	0.65	0.51	0.36
U.S. Mortgage-Backed Securities (MBS)	0.78	0.84	1.00	0.46	0.46	0.39
Global Bonds	0.49	0.65	0.46	1.00	0.56	0.53
U.S. Investment Grade (IG) Corporates (Corp)	0.25	0.51	0.46	0.56	1.00	0.79
Emerging Market (EM) Debt	0.06	0.36	0.39	0.53	0.79	1.00

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This shows that fixed income securities such as Global Bonds and Investment Grade Corporates may have only a 25-50% correlation of movement to U.S. Treasuries, with Emerging Market Debt essentially neutral.

Security Type

The type of debt securities also affects the reaction to rate changes. Bank Loans for example have a variable or floating rate usually with a lower credit quality. This is completely separate than TIPS which adjust principal for inflation, but have a core tightly associated with government securities. Emerging Market and High Yield Debt generally have higher credit risk, but they also often are affected less by rising rates. Mortgage-Backed Securities can have lower credit risk, but must consider unique items such as extension risk, or how rate changes will affect the volume of refinances. While a large variety of options can provide confusion, it can also provide opportunity in balancing the credit quality, interest, inflation, and extension risks inherent in the bond market.

"It is important to view the monetary system as a global system—that is, no country really exists in isolation." *- Michael Hastenstab, Portfolio Manager of the Templeton Global Bond Fund. Barron's Interview Oct 2012 by Lawrence C. Strauss.*

PART 2: HOW OUR BOND PORTFOLIO IS POSITIONED

Overview

Our approach is a pre-emptive one, positioning our portfolio to better withstand a rise in interest rates, whenever that does happen to occur. While no one seems to think this will happen tomorrow, when it does happen the popular belief is that it will be quick. The *Wall Street Journal's* Matt Wirz recently wrote about just this, citing the changing shift among large bond funds such as BlackRock Inc., TCW Group Inc., and Pacific Investment Management Co.

"Our approach is a pre-emptive one…"

"Rather than trying to guess exactly when that moment will happen, they are pre-emptively making investments that will pay off when it does. The moves include buying debt with floating interest rates that rise as overall rates climb, as well as interest-rate swaps and inflation-protected bonds that will also increase in value."
– Matt Wirz, Wall Street Journal, March 2013

In an effort to position our clients favorably for this inevitable interest rate rise, our bond portfolios have drastically scaled back their U.S. Government holdings, increased Global and General Intermediate Term Bonds, and added a new asset class in Emerging Market Debt. As shown in Figure 2 below, our current portfolio's bond holdings have been found to correlate very favorably when compared to U.S. Treasuries.

Figure 2 *(5 Year Period Ending 3/31/13)*	U.S. Treasuries	TGBAX	TGEIX	MWTIX	SGVAX
U.S. Treasuries	1.00	-0.02	-0.12	0.33	0.38
Templeton Global Bond Fund Adv	-0.02	1.00	0.67	0.47	0.21
TCW Emerging Markets Income Fund I	-0.12	0.67	1.00	0.65	0.37
Metropolitan West Total Return Bond Fund I	0.33	0.47	0.65	1.00	0.66
Western Asset Mortgage Backed Securities Fund A	0.38	0.21	0.37	0.66	1.00

 U.S. Treasuries represented by Barclays U.S. Intermediate Treasury Index. For illustrative purposes only. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance does not guarantee future results and results may differ over future time periods.**

"We don't subscribe to the view that once the fire starts, we'll be able to outrun everybody through the door," *- Stephen Kane, Managing Director for U.S. Fixed Income at TCW in Los Angeles. Wall Street Journal, March 2013.*

Fund by Fund Analysis

While we are utilizing specific asset classes in preparation for a rise in interest rates, the Fund Managers are also taking unique steps in preparing for an uncertain environment moving forward.

Templeton Global Bond Fund Advisor Class (TGBAX)

In the top 1% for its category for the 11 year tenure of its current portfolio manager, the Templeton Global Bond Fund is taking many steps to position itself favorably for a possible rate increase – effectively shown in the neutral correlation of Figure 2 (-0.02). The fund has lowered its duration to around 1.60 years, utilizing short term foreign debt in countries such as South Korea, Malaysia, Poland, Indonesia, and Brazil that have short term government bond rates anywhere from 2.5% to 8.5% – a drastic difference from short term rates in the U.S. Additionally, global currency holdings make up a large part of the portfolio, providing a potential further inflation hedge.

TCW Emerging Markets Income Fund Institutional Class (TGEIX)

Showing a slightly negative correlation to U.S. Treasuries (-0.12), the TCW Emerging Markets Income Fund has proven to be a steady performer, while staying true to its asset class. As discussed previously, Emerging Market Debt has been an asset class that can move against the general bond trends when domestic interest rates rise. The managers at TCW have taken those positive asset class trends and then added value on top of it – outperforming its Emerging Market Bond index the last 1, 3, 5, and 10 year periods *(JPM EMBI Global TR - Morningstar data ending 3/31/13).*

Metropolitan West Total Return Bond Fund Institutional Class (MWTIX)
An intermediate term fund with a lot of flexibility, this fund has positioned itself to have around 20% less duration and 35% less concentration in U.S. Government Securities when compared to its Barclays Aggregate benchmark index *(as of 3/31/13)*. Identifying opportunities in Asset, Commercial, and Mortgage Backed Securities, this fund also has the ability to utilize Global and Emerging Market Debt Securities that favorably present themselves.

Western Asset Mortgage Backed Securities Fund Class A (SGVAX)
Significantly scaled back due to its classification as a government bond fund, and therefore inherently more exposed to interest rate risk, this fund has demonstrated an ability to use what flexibility it does have to its advantage. Correlating to U.S. Treasuries in Figure 2 above at a surprisingly low 38%, its duration has been reduced from 3.9 years all the way to 2.26 years over the last month *(as of 4/30/13)*. Additionally, its flexibility includes being able to utilize Non-Agency Backed Securities within certain limitations.

PART 3: CASE STUDY FOR PREVIOUS RISING RATE PERIODS

While every period of rising interest rates acts uniquely depending on the contributing circumstances, and past history is no indication of future results, it can be interesting to see how funds have navigated previous rising rate periods.

Figure 3 – *Total Return in Rising Rates*	U.S. Treasuries	Barclays Aggregate	TGBAX	TGEIX	MWTIX	SGVAX
Fed Fund Rising Rate						
6/1/2004 – 6/30/2006	3.88%	6.54%	20.04%	27.49%	9.46%	5.28%
10 Year Treasury Rising Rate						
6/1/2003 – 5/31/2006	2.76%	5.84%	26.51%	33.86%	16.30%	3.46%
12/1/2008 – 4/30/2010	2.48%	13.01%	36.17%	72.25%	28.78%	14.37%
7/1/2012 – 3/31/2013	0.77%	1.68%	10.98%	13.01%	7.21%	1.68%

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As Figure 3 illustrates by examining the last number of recent rising rate periods, there are still possibilities for bond accumulations despite an environment of rising rates. Global and Emerging Market Bonds illustrate this well during the last period of consistent increases to the Federal Funds Rate, as our portfolio's global bond holding outperformed the Barclays Aggregate by over 13% during that two year time period of rising rates.

"…our portfolio's global bond holding outperformed Barclays Aggregate by over 13% during that two year time period of rising rates."

Summary

No one knows when rates will increase, only that they will increase at some point in time. However, with a vast amount of fixed income asset classes and security types, rising Treasury rates certainly do not equate to a common loss across the board. Based on current fund allocations and their past successful navigation of rising rate environments, we feel very favorably about our positioning and security selections in the bond market for the uncertain interest rate environment to come.