Klaas Investment Portfolio's (KIP) and Rising Rates

The Federal Reserve looks prepared to increase short term interest rates from zero this month at their December meeting. Fed fund futures are pricing the rate hike at a 75% likelihood, as the improving economy and labor markets no longer warrant such extreme accommodation. Yet, while the likelihood of a rate hike happening this month may be high, assurances have already been given that the pace will be slow and deliberate. The Fed has pledged that they remain focused on promoting economic growth and the strong dollar will likely limit how quickly the Fed raises rates in 2016.

It is likely the Fed will increase short rates through a 25 basis point move in December, then pause to assess the economic data before acting again. Assuming they follow this methodology next year, it is not expected that the Fed will raise rates after every meeting in 2016. It's more likely that this will occur once per quarter, which means the total percentage increase in interest rates for the year should be moderate and less than historical averages.

Positioning Portfolios for Rising Rates

While bonds are defined by regular interest payments, investors may not realize that over the long term, more than 90% of a bond's total return is generated by income rather than price movements. This is true for both investment grade and high yield bonds. If the Fed raises rates gradually over a longer period of time, as expected, the income on an investment can offset the decline in price. Because of this, income is a great defense against a moderately rising rate environment. Focusing portfolios on yield potential and reducing sensitivity to changes in interest rates can help offset price declines caused by rising rates.

In particular, Ladenburg Thalmann Asset Management, Inc. ("LTAM") believes the KIP portfolios they manage are well positioned for a December hike and period of rising rates going into 2016. Using 2013 as a proxy, a year when the 10-year Treasury yield went from 1.76% to 3.03%, they took a look at how the fixed income funds in their portfolios performed during that time frame and used this historical perspective to help determine how to properly position fixed income portfolios for what could be a similar situation next year.

CHART 1: 2013 Performance of LAMP Income Mutual Funds in LTAM portfolios vs. Fixed Income Indices

FIXED INCOME FUNDS	2013	FIXED INCOME INDICES	2013
DoubleLine Total Return	- 0.23%	Barclays Intermediate Govt/Credit	- 0.86%
MetWest Total Return	0.49%	Barclays Aggregate Bond	- 2.02%
Prudential Short Term Corporate	1.14%	Barclays Treasury 10-20 Year	- 8.39%
Oppenheimer Senior Floating	6.70%	Barclays Treasury 20+ Year	-13.88%
Goldman Sachs Strategic Income	6.42%	Barclays Corporate High Yield	7.44%

The historical returns for the Fixed Income Mutual Funds above are for illustrative purposes and future returns may be higher or lower than the returns shown.

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In 2013, fixed income positioning was successful due to a combination of:

- **Underweight duration**
  - The average effective duration of the fixed income positions in the Mutual Funds Growth & Income portfolio is 3.26 years.
  - This compares favorably with the Barclays Intermediate Govt/Credit (3.97 years) and Barclays Aggregate Bond (5.67 years).
- **Overweight to less interest rate sensitive areas**
  - Corporate bonds, particularly in the high yield and floating rate segment have historically outperformed in a rising rate environment.
  - High yield bonds can be an important source of income in a low rate environment and are better able to withstand rising rates because their higher coupons help offset capital losses.
- **Diversification**
  - Investing beyond traditional "core" U.S. investment grade bonds provides benefits, regardless of the rate and inflationary environments.
  - Historically, a broadly diversified fixed income portfolio — one including global corporate, emerging market, and high yield bonds, among others — has provided better annualized returns than many individual bond sectors, with less overall volatility.

In short, LTAM does not believe a rising rate environment should cause investors to fear fixed income — as it is still a necessary component to a diversified asset allocation. Bonds have proven over time that they are the ultimate diversifier to stocks and can help mitigate risk from the equity market.

Additionally, they do not see a scenario where a quarter point rise in short rates creates turmoil in the economy. U.S. businesses will continue to have access to cheap capital, consumers will still be able to lock in historically low mortgage rates, and the economy should continue to expand at a moderate pace. A rate increase could also be a welcome Christmas present for many investors as it would begin to eliminate the uncertainty and market volatility every time the Fed speaks.

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