RAPPAPORT REICHES
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Balancing Fixed Income Decisions

Bonds play an important role in a portfolio. Many investors look to fixed income for safety, income, and added stability. They must weigh these priorities against concerns over future interest rates, inflation, the level of government debt, and other factors that might affect fixed income returns.

Striking this balance can be difficult in any market environment. Today's low interest rates provide a unique challenge that has sent many investors on a quest for higher-yielding bonds. This pursuit of yield invites more risk—some of which may not be apparent today, but will become so if rates rise in the future.

So, what's an investor to do? How can you make prudent fixed income decisions while also addressing today's low interest rates? Consider these principles:

Remember How Markets Work

One key investment principle is that in a well-functioning capital market, securities prices reflect all available information. Today's bond values reflect everything the market's participants know and anticipate about economic conditions, growth expectations, inflation, Fed monetary policy, and the like. So, according to this principle, the possibility of rising interest rates is already factored into fixed income prices.

This is one reason investors should view future interest rate movements as unpredictable. Even the market experts who have access to vast amounts of research have a hard time predicting the direction of interest rates. For instance, despite regular predictions of rising rates over the past two years, nominal yields on US Treasuries and longer-term bonds have continued falling and now are at historic lows.

Rather than trying to predict macroeconomic forces that are difficult to foresee, investors can look to the market to set prices and focus on the variables within their control.

> **The Value Added Indexing℠ Advantage**
>
> The bond funds we utilize closely track established benchmarks. This precision allows us to target and monitor risk levels — both of individual bond funds and the bond portfolio as a whole.

Know What You Own

Investors should always strive for transparency in a portfolio. This means understanding an investment manager's basic strategy and knowing how the

5202 Old Orchard Road · Suite 160 · Skokie, Illinois 60077
Tel 847.832.0030 · Fax 847.832.0033 · rrcapital.com

instruments held in the portfolio might respond in different economic, market, and interest rate scenarios.

Unfortunately, investors often make their investment decisions based on the past performance or current popularity of a strategy. For example, some of the bond funds currently receiving the highest inflows of cash invest in higher yielding bonds. Theses higher yields are typically accompanied by higher risks. Many investors are unaware of the risks their managers are taking to deliver attractive yields.

Understand the Tradeoffs

In the fixed income market, investors have two primary ways to increase expected yield and returns on bonds. They can:

- Extend the overall maturity of their bond portfolio (take more "term risk").
- Hold bonds of lower credit quality (take more "credit risk").

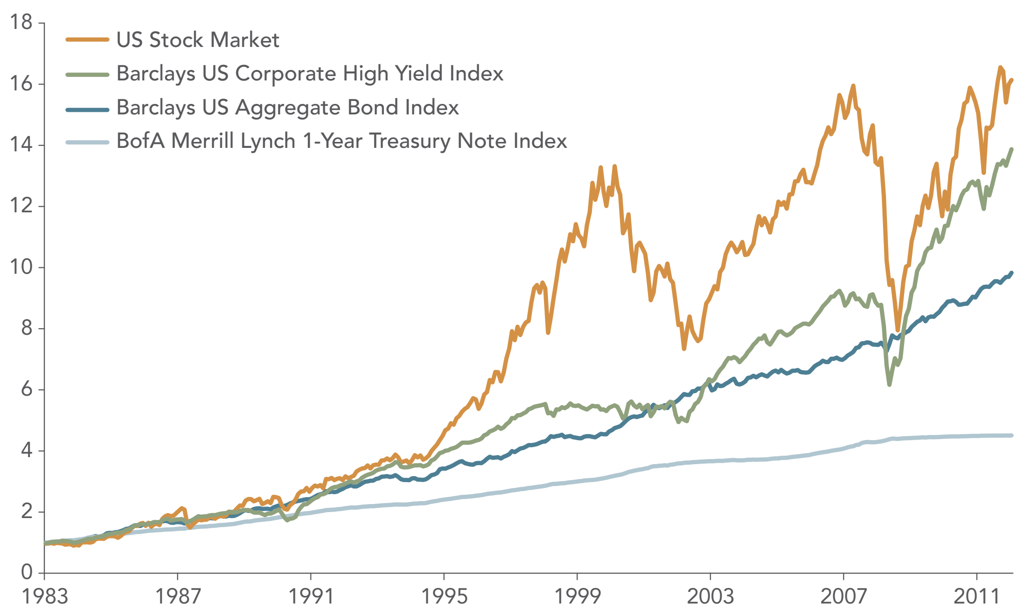
Pursuing higher returns means accepting more risk, as measured by interest rate movements, price volatility, or greater odds of losing value if the issuer's credit worthiness falls.

When interest rates rise, the value of an existing bond declines. The market adjusts an existing bond's price downward, so that its yield will match that available on a new bond. Investors who have bought bonds or bond funds with longer maturities in order to increase their yields are more exposed to "term risk." Investors who own shorter maturity bonds or bond funds have less exposure to this risk.

In periods of economic distress, investors have greater concern about bonds issued by companies that are rated below investment-grade. These high-yield or "junk" bonds, as shown in the graph below (as represented by the Barclays Capital US Corporate High Yield Index), have exhibited much higher volatility than other bonds.

Higher Yield Often Comes with More Volatility[1]

Monthly Growth of Wealth, July 1983 – July 2012



In the credit crisis of 2008, high yield bonds acted very much like stocks, with overall losses approaching 30%.

Pay Attention to Costs

> **The Value Added Indexing℠ Advantage**
>
> The bond funds we utilize are among the lowest cost available.

Investors may not realize that investment-related costs determine a large part of a portfolio's yield and return. This applies especially to fixed income securities. In fact, research has shown that a bond fund's expense ratio helps explain much of its net performance—and funds with the highest expenses tend to have the lowest performance within their peer group.[2]

Diversify

The concept of diversification, usually associated with stock investing, applies equally to bonds. All too often investors will own only a handful of individual bonds. Should one or more of these bonds experience credit problems, or even default, the effect can be devastating.

Diversified bond portfolios will own many different sectors of the bond markets. Depending on an investor's circumstances, a diversified portfolio may include:

- Tax-exempt (municipal) bonds
- U.S. Treasury bonds
- U.S. Government Agency bonds
- Mortgage-backed bonds
- Inflation-Protected bonds
- Investment Grade Corporate bonds
- International bonds

Summary

No one really knows when and by how much interest rates will change. Many market pundits have forecasted an upward move for several years now. Investors looking for higher bond yields should understand the higher risks associated with different strategies. Most investors would be best-served by building a fixed income portfolio that complements their broader investment objectives. In addition, understanding the sources of risk and expected return, paying attention to fees, and obtaining broad diversification can help balance fixed income decisions.

Endnotes

1. US Stock Market represented by CRSP Deciles 1-10 Index (market); data provided by the Center for Research in Security Prices, University of Chicago. Barclays Capital data provided by Barclays Bank PLC. BofA Merrill Lynch Indices are used with permission; copyright 2012 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. Merrill Lynch, Pierce, Fenner & Smith Incorporated is a wholly owned subsidiary of Bank of America Corporation.

CRSP data includes indices of securities in each decile as well as other segments of NYSE securities (plus AMEX equivalents since July 1962 and NASDAQ equivalents since 1973). The Barclays Capital US Corporate High Yield index measures the performance of fixed-rate, non-investment grade debt. The Barclays Capital US Aggregate Bond Index measures the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market. The BofA Merrill Lynch One-Year Treasury Note Index measures the performance of US Treasury notes. The index is representative of the universe of fixed-rate, non-investment grade debt. Indices are not investment products available for purchase.

2. The study examined monthly alpha and expense ratios for bond funds in the CRSP survivorship-bias-free mutual fund database from January 1992 to December 2011. Source: Dimensional Fund Advisors.

Disclosures

This information is for educational purposes only and should not be considered investment advice or an offer of any security for sale. Investing risks include loss of principal and fluctuating value. Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks including changes in credit quality, liquidity, prepayments, and other factors.

Past performance is no guarantee of future results, and every investment strategy has a potential for profit or loss.

Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Nothing herein constitutes (i) legal, accounting or tax advice, (ii) a recommendation to buy, sell or hold a security or (iii) advice as to whether any investment strategy is suitable for a particular investor.

Rappaport Reiches Capital Management is an investment advisor delivering world-class global investment management and financial planning solutions to individuals and families. As an independent firm, we are beholden only to our clients' best interests.

Our Value Added Indexing℠ approach utilizes passive and index-related portfolios as part of a comprehensive solution to meet our clients' long term goals. The result is a disciplined investment experience based on sound research and planning, rather than forecasts, emotions or trends.

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