COMPASS WATCH

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WHAT MIGHT HAPPEN TO BONDS IF INTEREST RATES DOUBLE?

At the present time, the yield on the 10-year U.S. Treasury note is about 2%...near a historical low. The current assumption that rates must soon rise has many bondholders concerned because when interest rates rise, prices fall for the bonds they already own. But the change in price forms only part of a bonds' total return. Income is the other critical component—and the fact is, when interest rates rise, the income increases (as long as the "duration"[1] is not lengthened over time). At Compass, we limit our duration exposure by laddering our bonds. Laddering tends to perform well over the long-term because it simultaneously accomplishes two goals: 1) Returns maturing bonds at par for reinvestment and 2) Reinvests principal from low yielding bonds into new, higher yielding bonds. For illustrative purposes, let's assume we have a high-quality diversified bond ladder with an average yield of 2% and average duration of 4.6 years. How might this portfolio react to an unexpected doubling in interest rates?

	Today	+1 year	+2 year	+3 year	+4 year	+5 year
Yield (%)	2.00	4.00	4.00	4.00	4.00	4.00
Price Change (%)	0	(9.20)	0	0	0	0
Total Return (%)	2.00	(6.20)	4.00	4.00	4.00	4.00
Annualized Return (%)		(6.20)	(1.23)	**0.48**	1.35	1.87

As expected, the hypothetical impact of a doubling in interest rates would see a significant first year price decline, but for a total return investor, by year three, the diversified bond investor would be at break-even, simply by reinvesting interest distributions and the cash from bonds maturing in the portfolio.

Over the long-term, it is interest income and the reinvestment of that income plus bond maturities that accounts for the majority of a bond portfolio's total return. The impact of short-term price fluctuations can be more than offset by staying invested and reinvesting income, even if the future is similar to the rising rate environment of the late 1970s and early 1980s. According to the Federal Reserve, the yield on the 10-year Treasury more than doubled, rising from 6.90% (December 1976) to 15.30% (September 1981)[2], yet a hypothetical $1 million dollar investment made in 1976 would have grown to more than $2 million by the end of 1983. Not too bad for such a dramatic secular rise in interest rates.

At Compass, we invest in high-quality, intermediate-term bonds only in our portfolios rather than lowering quality and lengthening maturities. Additional virtues of our laddered bond investment management style include: 1) Having a fixed maturity date; 2) Generating a predictable level of income; and 3) Owning marketable (liquid) bonds. Successful investing is seldom easy, but using a sensible, long-term discipline and sticking with it takes much of the destructive emotion out of investing.

[1] Duration: A bond's price falls (rises) roughly 1% per year of duration for every percentage-point rise (decline) in market interest rates.
[2] Vanguard.

For more information regarding our company, disciplines and results, please call, write, e-mail or visit our website: www.compasscap.com

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