

# COMPASS WATCH

MARK S. HALVERSON

CHRISTOPHER C. KELLEY, CFA, CAIA

*A quarterly newsletter of Compass Capital Management, Inc.*

JAY M. JACKLEY, CIMA

LEIGH E. NIEBUHR

CHARLES M. KELLEY, CFA

MARK A. VITELLI, CFA

*Volume 29, Number 4: Winter 2017*

## REMEMBERING THE ROLE OF BONDS, EVEN IN A RISING RATE ENVIRONMENT

Interest rates continued to surge as the strong January jobs and wages report was released on February 2. This rate surge indicated that robust global economic data is helping investors to overcome longstanding doubts about the staying power of the post-crisis recovery. The yield on the 10-year U.S. Treasury increased to 2.88%<sup>1</sup>, near a four-year high. This is up from 2.41% at the end of 2017.

The concern now seems to be that the Federal Reserve (“Fed”) may continue raising short-term rates for some time as they back away from the stimulative policies employed during the financial crisis. As the Fed raises interest rates and reduces the size of its bond portfolio, it is pulling money out of the economy precisely at a time financial markets are becoming increasingly volatile. In addition, the rise in interest rates has coincided with the passage of \$1.5 trillion in tax cuts, which could lead to larger budget deficits. These larger deficits could threaten to drive interest rates up even more as the government boosts the number of bonds it sells to finance these cuts.

These dynamics have led some investors to ask, “Should I still own bonds?” We believe bonds are as important today as ever. Even with the prospect of rising rates, bonds have attributes which are frequently overlooked or taken for granted, including:

**Transparency:** Few investments contain a contractual commitment to pay the investor a fixed amount of interest and principal (face value) on a maturity date known at the time of purchase. Bonds do. This is not true of other investments such as stocks, gold or real estate.

**Complement to Stocks:** Bonds also play an important complementary role to stocks in a portfolio. While many investors buy stocks for growth, bonds help mitigate risk and volatility. The table below illustrates how bonds help protect portfolios.

	Risk/Volatility (1926-2017) <sup>2</sup> (92 Years)	
	S&P 500 Index	Intermediate U.S. Government Bonds
Worst Annual Return	(43.34%)	(5.14%)
Number of Negative Return Years	24	10

**Predictable Cash Flows:** As bond investors know, higher interest rates mean lower prices for most already-issued bonds. These price changes are inconsequential for investors who hold bonds to maturity, like Compass does. As bonds mature, new streams of cash become available that can be reinvested in higher-yielding bonds. Over time, the portfolio’s yield will gradually increase, resulting in a higher income stream that will eventually outweigh losses from price depreciation.

A major advantage of the Compass bond style is that it is easily understood and avoids the ongoing management fee associated with bond mutual funds. Our clients know what we are doing and why. We have been following a single bond discipline successfully since 1988. We construct our bond portfolios by equally-weighting our maturities 1-10 years. We “ladder” to mitigate risk and control volatility within the portfolio. **The primary goal of a laddered bond portfolio is to achieve a total return over various interest rate cycles comparable to that of a longer-term bond, but with less market risk.** At Compass, managing individual fixed income portfolios (or as part of a larger balanced portfolio) is a significant component of our total assets under management (approximately 30%). We have the flexibility to customize our tax-exempt portfolios (purchase state specific or national bonds depending on whether you are a resident of Minnesota or California, for example) and our clients benefit from the “institutional” pricing we are able to leverage from the bond dealers with whom we utilize.

At Compass, we are fond of saying “bonds are beautiful,” which still holds true in today’s market. If you are interested in learning more about how we manage our bond portfolios, give us a call. How may we help?

<sup>1</sup>As of 3/20/18

<sup>2</sup>Ibbotson Associates, Bloomberg

For more information regarding our company, disciplines and results; please call, write, e-mail or visit our website: [www.compasscap.com](http://www.compasscap.com)

Compass Capital Management, Inc. \* 706 Second Avenue South \* Suite 400 \* Minneapolis, MN 55402 \* (612) 338-4051