COMPASS WATCH

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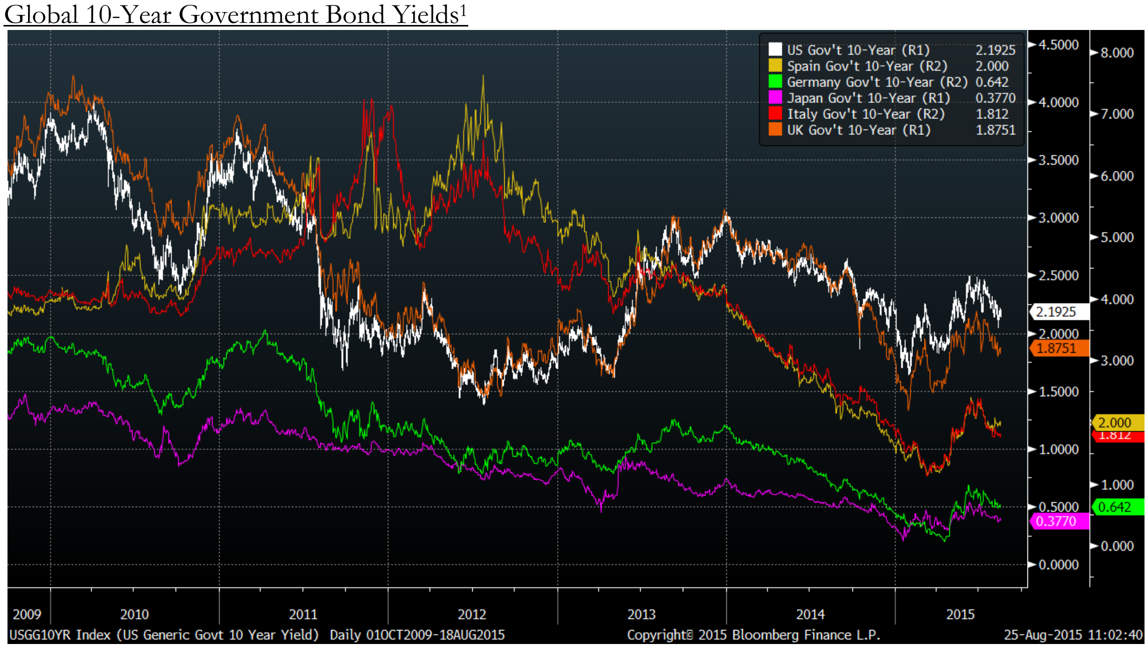
INVESTMENT MISTAKE #6: ALLOWING PUBLIC PERCEPTIONS TO DRIVE YOUR FIXED INCOME PORTFOLIO

Many market pundits continue to declare that higher interest rates are coming, predicting bad news for fixed income investors. As Compass bond investors already know, higher rates (yields) mean lower prices for most already-issued bonds (but for those holding bonds to maturity, like we do, this declaration is a moot point). The futures market suggests that the Federal Reserve is likely to increase its target for the Federal Funds rate (the interest rate which commercial banks charge each other for overnight loans to meet reserve requirements) later this year. Most investors take this to mean bond interest rates are headed higher. What's not well understood is that the Fed does not set or directly control intermediate and long-term interest rates. These rates are a function of bond investors' maturity needs and market inflation expectations. Assuming long-term rates were to begin to rise in the near term, the strengthening of the U.S. dollar and weakening global currencies may continue to attract foreign capital to U.S. bond markets, continuing to hold down our interest rates. The global 10-year government bond rates in Germany, Japan & U.K are well below U.S. rates making U.S. returns look attractive. Even countries like Italy and Spain with lower credit ratings are paying lower rates than the United States!

Global 10-Year Government Bond Yields[1]



Moreover, as we have witnessed many times historically, the credit rating of the U.S. will continue to draw investors seeking liquidity and political stability. The result? Many global *and* U.S. investors are likely to demand U.S. debt. This ought to keep a lid on intermediate-term rates no matter what the Fed does.

We don't claim to be able to predict the future with precision either. Fortunately, successful investing doesn't depend on that ability. At Compass, we have been following a single 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 to that of a longer-term bond, but with less market risk.** At Compass, managing fixed income portfolios (or as part of a larger balanced portfolio) are a significant piece of our total assets under management (approximately 40%). We also have the flexibility to customize our tax-exempt portfolios (i.e. purchase state specific or national bonds depending if you are a Minnesota or California resident, for example). Additionally, our clients benefit from the "institutional" pricing we can leverage from the bond dealers we utilize.

Don't let public perceptions drive your bond investing. Frankly, with the serious money approach Compass employs on behalf of our clients, many of whom depend on their bond segments for capital preservation, liquidity and income; we would be excited about the prospect of higher interest income that higher rates might bring someday.

[1] Bloomberg, Aug. 25, 2015
Previous *Compass Watch* "Investment Mistake" articles are: #1: Chasing Returns; #2: Ignoring Risk; #3: Lack of Discipline; #4: Investing In Things You Don't Understand and #5: Chasing Yields.

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