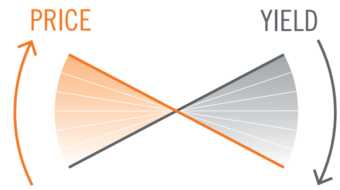
PREPARE FOR (BUT DON'T PREDICT) INTEREST RATE HIKES

VIRTUS INVESTMENT PARTNERS

There is probably no greater fear in the global capital markets now than the prospect of rising interest rates.

One current fear in the global capital markets is the prospect of continued rising interest rates. With global bond yields still at low levels, we remain in uncertain territory. In the case that rates rise quickly, losses could be large—including for retired investors who need portfolio stability.

One thing all fixed income investors know is that bond yields and bond prices are inversely related—as captured in the classic "seesaw" diagram. When yields move up, prices fall, and vice-versa.



How should you position your bond portfolios to avoid the damage of higher rates—whenever they might come?

We have four beliefs:

1. Prognostication about macro events, including rate hikes, is not productive. But **preparation** is the centerpiece of a well-managed portfolio.
2. The relationship between yield and price is a bit more complicated than the "seesaw" reveals—which is **good** for investors.
3. Bond investors with longer time horizons ultimately **benefit** from a higher rate environment.
4. Active management in the bond market is **critical** for achieving the right results.

Dartboards and duration

Guessing the direction of interest rates is a favorite market pastime for many, yet even the so-called experts frequently get this wrong. Indeed, the "bet" that aggressive monetary policy in the post-crisis era would trigger spiraling rate increases has been, well, wrong. Prior to the recent interest rate increases, rates had fallen, not risen, over the past eight years.

Without a crystal ball, the question remains how to find the "sweet spots" of the bond market that provide reasonable returns without undue (and hard-to-predict) risk.

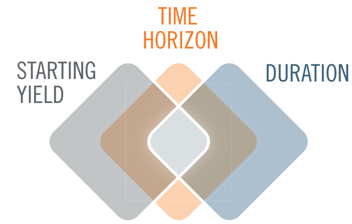
Below Recent Highs

Source: FactSet

Past performance is not indicative of future results.

Three considerations

Fortunately, there are just three key factors at work in helping us solve this problem—which produce some counter-intuitive insights.



While the seesaw shows a simple relationship between price and yield, the real world problems of rate-worried bond investors are addressed by a bond's yield, its interest rate sensitivity (or duration), and the investor's own time horizon.

Take a look at the following scenarios of gains and losses based on a 1% (100 bps) increase in rates*:

Time is on your side

TIME HORIZON		6 Months				18 Months				36 Months			
STARTING YIELD		1%	2%	3%	4%	1%	2%	3%	4%	1%	2%	3%	4%
DURATION	2	-1.5	-1.0	-0.5	0.0	-0.5	1.0	2.6	4.2	1.0	4.2	7.4	10.7
	3	-2.6	-2.1	-1.6	-1.1	-1.6	0.0	1.5	3.1	0.0	3.1	6.3	9.6
	4	-3.7	-3.2	-2.7	-2.2	-2.7	-1.2	0.4	2.0	-1.2	2.0	5.2	8.5
	5	-4.9	-4.4	-3.9	-3.4	-3.9	-2.4	-0.8	0.8	-2.4	0.8	4.0	7.3

Source: Newfleet Asset Management

These tables powerfully illustrate that the conventional view that rising rates will crush bonds is largely untrue. As is expected, bonds with more interest rate exposure will suffer more when rates rise in the very near term. Yet, there's nothing new about rate increases—for instance, in the period from 2004 to 2006 alone, there were 17 rate hikes. What is new is that previous periods have had much larger starting yields to buffer duration-driven losses. A reasonably larger starting yield moves us from red to green relatively quickly. A head start is usually key to winning a race.

As is stamina. Investing in bonds—as distinct from trading them—allows for income streams to compound over the longer haul, even when the temporary price decline might feel worrisome. The shift from red to green in the picture above in a relatively brief period shows this to be true. Understanding this is a key to preparing an appropriate bond allocation.

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The need for active management

In a world of growing complexity, navigating the global bond market requires professional active management. While the insights above should comfort bond investors, especially those concerned about a major spike in bond yields, it's still critical to align with the right partner who brings to bear the right team, perspectives, and tools.

Success in today's bond market requires the flexibility to invest across multiple sectors where the best prospective risk-adjusted returns can be found, and a professional manager with access to and the expertise to operate in those markets.

Indeed, the illustration above is, in fact, a worst-case scenario, insofar as we focused just on interest rate sensitivity without taking into account the other major "dial" in bond returns: Credit. In more-realistic scenarios, bond investors will also take on exposure to credit, a risk distinct from duration. Getting credit "right" requires both deep bottom-up analytics on individual issuers as well as a big picture sense of where to find pockets of value. Understanding—and profiting from—the dynamic trade-off of credit versus duration risk is a hallmark of the savvy active manager during these unprecedented times.

To learn more, please contact us at 1-800-243-4361 or visit virtus.com.

*Returns measure total returns over "time to shift" (e.g., a 1% increase over a 6-month period, or a 1% increase over an 18-month period. Based on the yield curve as of 3/31/17.)

Past performance is not indicative of future results.