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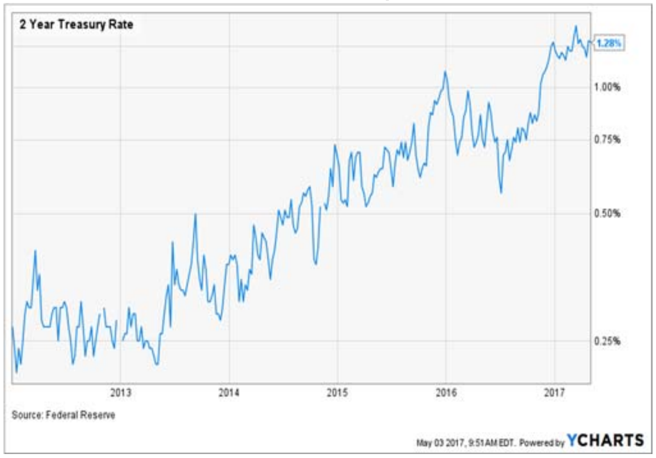
Managing the Investment Portfolio During Interest Rate Uncertainty

Having already increased interest rates to the 0.75 - 1.00% range in March 2017, the Federal Reserve (Fed) is projecting two additional rate increases this year and another three in 2018. If the Fed's projection comes to fruition, the high end of the federal funds rate range will be 2.25% by the end of next year. The market remains less optimistic, predicting only an additional 38 basis points of tightening over the next twelve months. Investors are also preparing for a potential reduction in the Fed's balance sheet starting later this year. The balance sheet currently consists of $2.5 trillion in Treasuries and $1.8 trillion in Agency Mortgage-Backed Securities. Methodically allowing securities to roll-off in a "passive and predictable manner" appears to be the approach most favored by current Fed members. Some market participants believe that any wind-down of the balance sheet could result in an approximate 20 basis point move higher on the short-end of the curve.

2 Year Treasury Rate



As illustrated in the chart above, short rates recently moved higher, emphasizing the importance of short-term cash management. Minor tweaks to where on the curve an investor is buying can make a significant difference in that portfolio's ability to withstand more potential rate increases, while at the same time presenting opportunities for liquidation and reinvestment of those assets should rates remain unchanged or fall. A volatile and uncertain rate environment lends itself to more active management, potentially leading to better overall yield.

Investors frequently purchase step-up callable securities to protect against higher rates. The bull market in bonds over the last 30+ years resulted in continually falling rates, enabling step-up bonds to be called away at par, resulting in no market loss. Unfortunately, these step-up bonds are called away in low interest rate environments, causing the buyer to reinvest at lower rates. If rates move higher and the bond is not called away, the yield-to-worst moves from the next call date to the maturity date, thereby lengthening duration and increasing price volatility. While step-ups perform well under very specific interest rate scenarios, those scenarios can be very difficult to project. In addition, the choice of whether or not to call a step-up, or any callable security for that matter, lies with the issuer and not the investor.

Corporate securities can be a beneficial addition to many portfolios if the investment policy allows and the investor is comfortable with the sector. Corporates can limit duration risk and simultaneously pick up added income versus other investment options. In today's rate environment where there is concern regarding rising rates (especially on the shorter-end of the curve), a portfolio comprised of a least a small percentage of corporates can produce a total return (income +/- price) superior to that of a portfolio comprised only of Treasuries.

Ultimately, no one knows for certain the future direction of interest rates. However, an active approach to portfolio management is needed now more than ever. In an environment of low interest rates with the potential for higher rates, making the wrong decision could impact the portfolio for many years to come. Knowing when and what to buy or sell can be key. It's important to maximize performance should rates move as anticipated and limit the damage if they do not.

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