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Rates Spring Up

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SEI Fixed Income Portfolio Management (SFIPM) manages fixed-income strategies for SEI's Managed Account Solutions (MAS).

Snapshot

- Central banks, led by the Federal Reserve, and raising short-term rates.
- It's tempting for investors to try to time rising rates; however, we believe investors should focus on staying fully invested rather than sitting on the sidelines and waiting.
- There are several straightforward investment strategies that investors can employ to combat rising rates, but for investors seeking transparency and income a low-turnover, laddered bond portfolio may be an effective solution.

For roughly the past year, we have been witness to a period of global synchronized economic growth. The world's major central banks, fearing that the global economy will overheat, have or may soon start reversing the accommodative monetary policies that were put in place to spur economic recovery following the global financial crisis. Already the European Central Bank has moved to reduce its asset purchases, the Bank of England has hiked rates and the Federal Reserve (Fed) has done both, leaving the Bank of Japan as the only leading central bank to not tighten monetary policy.

Fed Marches Higher

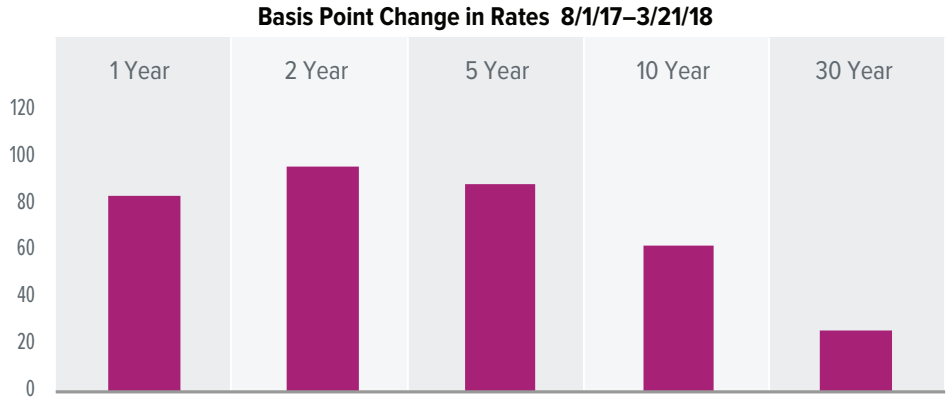
The Fed is the world's most prominent central bank and sets its monetary policy through the Federal Open Market Committee (FOMC). Under the previous Fed Chair Janet Yellen and more recently under current Fed Chair Jerome Powell, the Fed has sought to telegraph its moves in an effort to maintain calm in capital markets. The FOMC hiked rates three times in 2017 and has indicated that it expects to hike three times in 2018, with the first hike announced at the conclusion of the March 22 FOMC meeting. Whether the FOMC actually gets to three hikes or not remains to be seen, the central bank is unquestionably in the midst of a rate hiking cycle while also reducing its balance sheet.

Timing is a Fool's Game

While many investors recognize the important role played by fixed-income investments in a diversified portfolio, even these savvy investors are often tempted to reduce their strategic, long-term allocations to fixed income when interest rates start to rise. This sentiment is understandable given the inverse relationship that interest rates and yields have with bond prices, but we believe it's generally a bad decision that often leads to poor results.

It's appealing to think that one can time their investments to achieve higher yields and avoid losses as the market discounts lower-yielding bonds, but market timing is notoriously difficult to get right. If you're reading this and considering action, it's already too late, rates have already moved significantly higher. Excluding 30-year U.S. Treasury Bonds, which are anchored by marginal inflation pressures, the rest of the curve has risen by more than 60 basis points (as basis point equals 0.01%).

Exhibit 1: Yield Curve Shifts Higher



Source: U.S. Department of the Treasury, SEI

Higher Rates are no Reason for a May Day

We believe the top priority for investors should be to stay invested, and there are multiple strategies that investors can employ in an effort to help combat higher rates.

One way investors attempt to mitigate rising interest rates is through actively managed strategies. Within the fixed-income space, actively managed strategies can offer many benefits and often perform well over long time horizons. However in a rising rate environment results can be a mixed bag as active strategies tend to have higher turnover rates and therefore carry more risk that potential losses will be realized when the portfolio is repositioned. While active strategies have often been effective, they also have additional risks that more passive, lower-turnover strategies do not.

A popular low-turnover strategy is to create a "barbell" portfolio, focusing on short- and long-term bonds while largely ignoring maturities in the middle part of the yield curve. An advantage of the barbell approach is that, by partially focusing on the long end of the yield curve, it typically allows for a portfolio with a higher yield than many other low-turnover strategies. This also presents a challenge though as those same securities are more sensitive to rate changes than shorter-dated bonds.

Another popular low-turnover strategy is to “ladder” the portfolio. This strategy spreads assets evenly over a segment of the yield curve up to the desired maturity. For example a five-year laddered portfolio may buy bonds with maturities of one, two, three, four and five years. At the end of the first year, the one-year bond would mature and the investor would replace it with a new five-year bond, keeping the laddered term structure in place. This process can then be repeated year after year. The benefits of the laddered strategy are that an investor may never have to realize losses from higher interest rates (as bonds will mature and return the principal amount to the investor). In order to realize this benefit, the investor must hold all bonds until they mature and not experience any bond defaults. Under this strategy, when the shortest-dated bond matures, the proceeds are used to purchase what will now be the longest dated bond. This new bond effectively trades at a fair value relative to the higher rates and helps the portfolio’s yield keep a closer pace with rising interest rates.

The aforementioned strategies all have their merits in the fight against rising rates, but to reiterate, we believe first and foremost that it is necessary to remain invested. For most investors looking for transparency and income, we believe a laddered bond strategy is highly effective in a rising rate environment. It’s a straight- forward approach that’s easy to understand and allows investors to stay invested while also adding bonds with higher yields to the portfolio over time. Further, the strategy’s low-turnover nature essentially eliminates realized losses (assuming the portfolio does not experience any bond defaults) simply by holding all securities to maturity.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk. There is no assurance the goals of the strategies discussed will be met. Bonds and bond funds will decrease in value as interest rates rise.

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