Potential impact of rising rates

By Russell fixed income team

The phrase "bond bubble" continues to come up – perhaps you have even used it. But, what does it really imply – and are we in one or not?

Let's be honest. Most would agree that rates *will* continue to go up. We also know that interest rates and bond prices move in opposite directions – but not necessarily in a one-to-one ratio. We believe that fixed income is shifting from a period of extraordinary returns to more historically ordinary returns, but that the math driving "bond bubble" fears just doesn't add up.

In order for a true "bubble" (say a 10% or greater drop in bond prices within one year) to occur, we think several things would need to happen simultaneously, including:

- A material spike in the U.S. treasury yield
- Vast improvement in unemployment
- A sharp rise in interest rates by the Federal Reserve*

We believe the likelihood of these events happening concurrently is extremely low in the next couple years. Additionally, active portfolio managers, like those who implement changes in Russell's multi-asset portfolios, are able to adjust portfolios to seek to navigate changes in interest rates – particularly when they don't rise drastically overnight.

Besides, we believe that bonds still have an important role to play in an overall portfolio.

**A note here about taper talk: you may hear this term and assume drastic measures are in order; however, a gentle reminder that tapering doesn't necessarily equate to immediate subsequent interest rate hikes may help ease their fears*.

The role of bonds in a portfolio

While it's natural for investors to want all the pieces of their portfolio to move upwards, all the time, it's not realistic. That's why they diversify in multiple asset classes that have historically had low correlation with each other. Diversification, while it doesn't guarantee a profit or protect against loss, is a balancing act.

Equities and bonds have historically had low correlation with each other, making them a good pair in a multi-asset portfolio. At Russell, we believe bonds continue to play three critical roles in a portfolio:

- **Diversification:** while there are no guarantees, historically, bond portfolios have provided an attractive haven in times of equity market stress. When equity markets have experienced severe declines, bonds have tended to hold up better. Think back to 2008, when the Barclays U.S. Aggregate Bond Index and the Russell 3000® Index had a return difference of 43%.
- **Capital preservation:** inflation and default risk aside, bonds by their very nature pay back their par value if held through maturity.
- **Yield:** while not guaranteed, even when rising rates affect bond returns, we expect the coupon payments to contribute to a bond's total return.

As a result, we caution against eliminating bonds from your portfolios because of fears of a rising rate environment. Particularly actively managed bonds

Russell in Action

In today's environment, Russell believes it's critical that investors remain vigilant about the potential risks in their fixed income portfolios and take active approaches to potentially avert harmful outcomes as interest rates rise. We believe that active portfolio management allows for flexibility in portfolio implementation to seek to navigate changes in a rising rate environment.

For instance, in June 2012, Russell made proactive changes to the Russell fixed income funds in anticipation of rising interest rates. Specifically, our changes were designed to help temper or reduce the impact of rising rates, by:

- actively managing duration risk
- seeking additional sources of return through adjusting credit exposure
- increasing global diversification through country and currency exposure

Of course, some of these strategies can introduce additional risks (beyond the usual interest rate, credit, repurchase and reverse transaction risks inherent in bond investing), such as including securities that have volatile prices and are illiquid. They can also expose investors to economic and political risks associated with foreign countries.