Russell Investments

Russell Research

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Short Duration Bonds: A better alternative to holding cash?

In today's uncertain markets, it is understandable why some investors prefer the safety of cash or money market funds. While it is true that these ultra low risk options provide strong protection against principal loss, does it really mean your wealth is preserved? This paper will demonstrate that money market funds in today's environment may not earn enough return to keep up with inflation. Thus, investors may be losing future purchasing power by not investing in higher-yielding instruments. Due to the current positively sloping yield curve and opportunities in the credit markets, short duration bond funds may be an attractive alternative to holding money market funds.

Why short duration bonds? Why now?

MONEY MARKET FUNDS ERODING FUTURE PURCHASING POWER

With short term interest rates currently anchored near zero, many money market funds are earning a *negative* yield after adjusting for inflation expectations. For example, we look at the yields of typical investments in money market funds – 3-month treasury bills and top tier (A1/P1/F1) commercial paper offered by dealers – and adjust them against various measures of realized and forecasted inflation.

Nominal Annualized Yields of Money Market Instruments	
US 3-Month Treasury Bill	US Top Tier 30-Day Commercial Paper
0.01%	0.38%

Various Measures of Realized and Forecasted Annual Inflation		Real Annualized Yields of Money Market Instruments: US 3-Month Treasury Bill	Real Annualized Yields of Money Market Instruments: US Top Tier 30-Day Commercial Paper
US CPI Urban Consumers YoY NSA	3.50%	-3.49%	-3.12%
US CPI Urban Consumers Less Food and Energy YoY NSA	2.10%	-2.09%	-1.72%
US Personal Consumption Expenditures YoY*	1.60%	-1.59%	-1.22%
Conference Board Consumer Confidence 12-month Inflation Expectations	5.80%	-5.79%	-5.42%
University of Michigan Survey 1 Year Ahead Inflation Expectations	3.20%	-3.19%	-2.82%
University of Michigan Survey 5 to 10 Year Ahead Inflation Expectations	2.70%	-2.69%	-2.32%

Source: Bloomberg, 10/31/2011
*As of 9/30/2011

Note: "Typical Range" represents the range in which 90% of historical results fall within.
Source: Cash yields (1-3 month treasury bills) sourced from U.S. Department of Treasury. Inflation measured by U.S. Personal Consumption Expenditure Price Index as of 9/30/2011.

We find that the yields on these money market instruments are well below what's needed to keep up with current and expected inflation, reducing future purchasing power. On a historical basis, the real yield of the 3-month treasury bill, as of 9/30/2011, is below the range in which 90% of observations fell since January 1950.

In addition, in response to the negative effects of the financial crisis on money market funds, the Securities and Exchange Commission (SEC) has recently made changes to rules governing the management of money market funds to make money market funds safer and more liquid[1]. While this is a positive development for investors looking for safer short-term liquidity, the more restrictive rule changes make it even harder for money market funds to keep up with inflation.

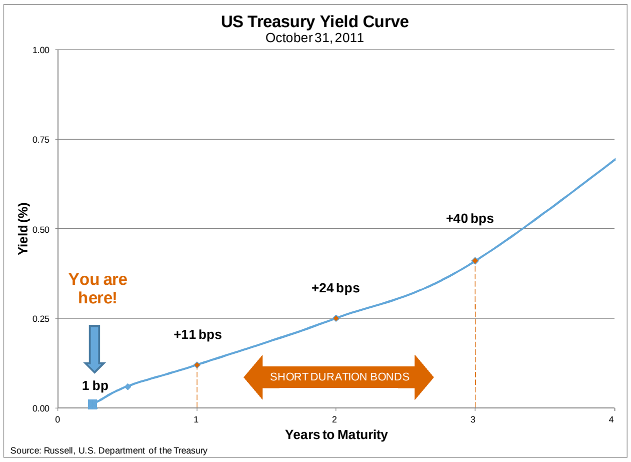
So how did we get here? In fact, the Federal Reserve's decision to keep the target Federal Funds Rate at 0 to 0.25% has in large part created this conundrum for money market funds. Since December 2008, the Federal Reserve has essentially been attempting to encourage investors to select investments riskier than money market funds in order to help stimulate economic recovery. On August 9, 2011, the Federal Reserve reiterated their interest rate policy by explicitly stating their commitment to keep short term rates at current levels until at least mid-2013[2].

MARKET OPPORTUNITIES BY EXTENDING FURTHER OUT ON THE YIELD CURVE

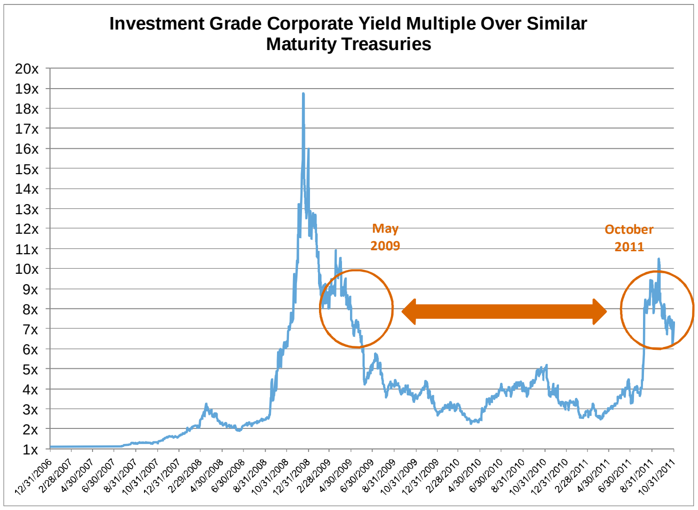
As the Federal Reserve intended, in order to earn higher yields, investors need to take on additional risk over money market funds. Short duration bonds give investors access to an attractive bundle of risks that represent the first step up the risk spectrum from money market funds. By investing in short duration bonds, investors collect a yield premium by taking on additional interest rate risk through longer maturity securities. Investors are also compensated for taking on additional credit and liquidity risks through investments in various credit sectors of fixed income. While these additional risks make short duration bonds more volatile in the short term, investors with investment horizons of 1 year or longer can benefit from the higher yield of short duration bonds to increase the chances of keeping up with inflation.

With short-term rates currently anchored, today's positively sloping yield curve allows for an additional yield pickup by moving into the 1-3 year maturity portion of the yield curve. Recall that the Federal Reserve has stated that it does not intend to raise interest rates until at least mid-2013, which should keep short maturity treasury yields anchored. This allows money market investors to collect a yield premium by investing in short duration bonds with a reduced concern of unexpected interest rate increases until at least mid-2013. While less likely, there is a risk that the Federal Reserve unexpectedly increases interest rates earlier than currently communicated. In such an event, short duration bonds could suffer a loss, all else being equal (e.g. assuming spreads stay constant).

[1] www.sec.gov/rules/final/2010/ic-29132.pdf
[2] http://www.federalreserve.gov/newsevents/press/monetary/20110809a.htm

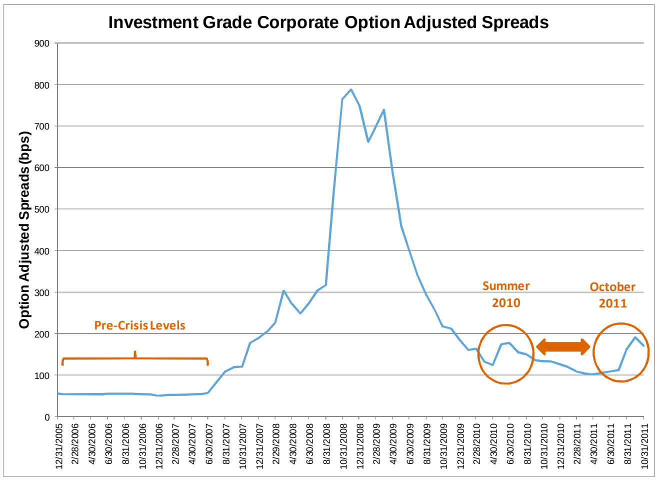


In addition to a higher risk-free yield, the 1-3 year bucket offers an expanded investment opportunity set which includes a full spectrum of spread sectors that can pay an additional yield over treasuries, resulting in greater return opportunities. Market volatility and economic uncertainty over the last three years have also created some very attractive investment opportunities in these spread sectors. For example, the most recent market selloff in August and September has created an attractive opportunity for short-term investment grade corporate bonds in the 1-3 year maturity bucket. With short-dated treasury yields dropping during the recent treasury rally, investment grade corporate bonds now offer approximately seven times the yield of similar maturity treasuries. Of course, investors should bear in mind that compared to treasuries, investment grade corporate bonds have historically had a higher risk of default. Nevertheless, the last time short-dated investment grade corporate bonds reached these multiples was in May of 2009.



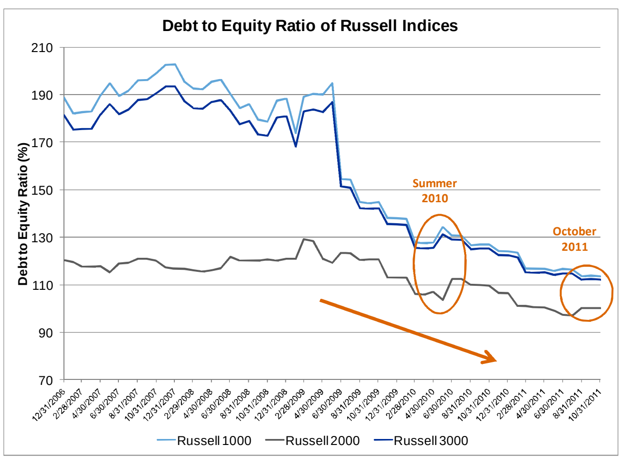
Source: BofAML 1-3 Year U.S. Treasuries Index (G1O2). BofAML 1-3 Year U.S. Corporates Index (C1A0) Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

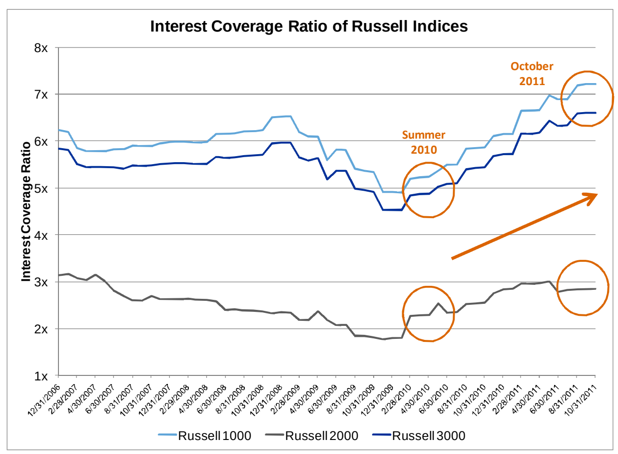
Looking purely at the option adjusted spread component of investment grade corporate yields, the recent August and September selloff increased spreads to summer 2010 levels (during the first wave of concerns over the European sovereign debt crisis) and still well above the pre-crisis level of approximately 50 bps.



Source: BofAML 1-3 Year U.S. Corporates Index (C1A0). Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

This creates an attractive investment opportunity as corporate fundamentals (as measured by Russell equity indices) have actually been improving through reduction of leverage (debt-to-equity ratio) and improvement in the ability to service debt (interest coverage ratio).





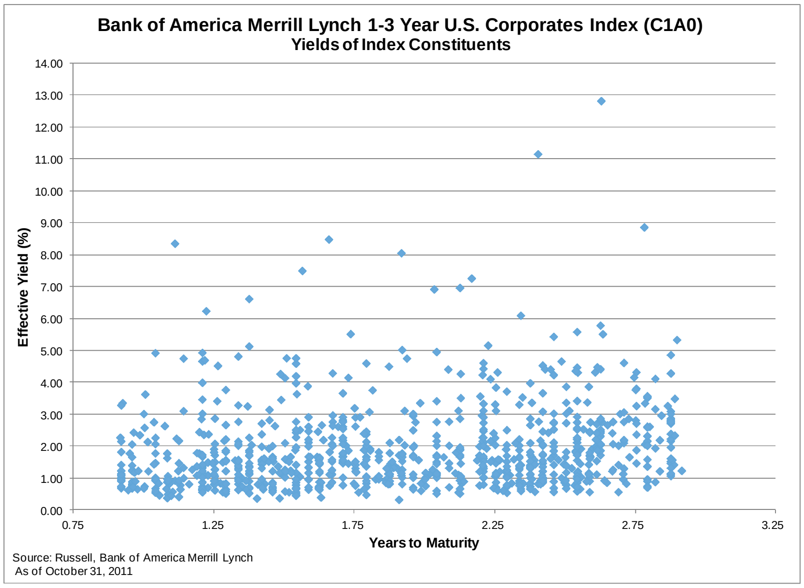
Note: Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. The Russell 3000® Index represents the broad equity market. The Russell 1000® Index represents the one thousand largest market capitalization companies in the Russell 3000 Index. The Russell 2000® Index represents the two thousand smallest market capitalization companies in the Russell 3000 Index.

Why manage short duration bonds actively?

In today's low yield environment, generating returns high enough to beat inflation requires capturing investment opportunities across all sectors of fixed income. Skilled investment managers can generate better returns by leveraging their strengths to add value primarily in the following ways:

SECURITY SELECTION

The yields of securities in spread sectors tend to be much more varied. This dispersion allows skilled investment managers with best-in-class research abilities to hand pick securities in the market place that they anticipate will perform better than the broader market.



Source: Russell Investments, Bank of America Merrill Lynch. Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

SECTOR ROTATION

Active managers also monitor all the different fixed income sectors, including those sectors that are outside of the traditional "core" fixed income sectors. These non-core sectors, commonly referred to as "extended sectors," include riskier securities such as high yield corporate bonds, emerging market debt, and non-agency mortgage-backed securities. By constantly evaluating the relative attractiveness of each sector, experienced investment managers can generate returns by increasing exposures to sectors that are expected to perform better and decreasing exposures to those that aren't.

DURATION TILTING

Duration is the sensitivity of your bond or portfolio to changes in interest rates. While a more volatile source of generating additional return, managers who have skills in predicting movements of interest rates can potentially add value by increasing interest rate sensitivity when interest rates are coming down and vice versa. All else being equal, when interest rates go down, bond prices go up.

Disclosures

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Bond investors should carefully consider risks such as interest rate, credit, repurchase and reverse repurchase transaction risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage backed securities, especially mortgage backed securities with exposure to sub-prime mortgages. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

Russell 2000® Index measures the performance of the especially large cap segment of the U.S. equity universe represented by stocks in the largest 200 by market cap that exhibit value characteristics.

Russell 3000® Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

BofA Merrill Lynch 1-3 Year U.S. Corporate Index is a subset of the BofA Merrill Lynch US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publically issued in the US domestic market. This subset includes all securities with a remaining term to maturity of less than 3 years.

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