

Whipped Around

by George Strickland
Portfolio Manager

If you are feeling a little “whipped around” lately by roller-coaster interest rates, you are not alone. A year ago, Bloomberg News surveyed 53 economists. The median estimate predicted the 10-year Treasury note would yield 5% in September 2004. It closed September 22nd at 3.98%. That’s a pretty big miss, but it is hardly unusual. *The Wall Street Journal* has published a similar survey of economists semi-annually since 1982. Bianco Research pointed out in July of 2003 that over the life of the survey, the consensus forecast has correctly predicted the *direction* of interest rates only 30% of the time. One would expect a coin toss to get the direction right 50% of the time.

It is tempting, but not my intention, to belittle economists. Most of them are highly trained, very intelligent, and have access to thousands of statistics and data series. It is simply a very difficult task to accurately predict the future direction of interest rates, and even harder to predict the magnitude of change.

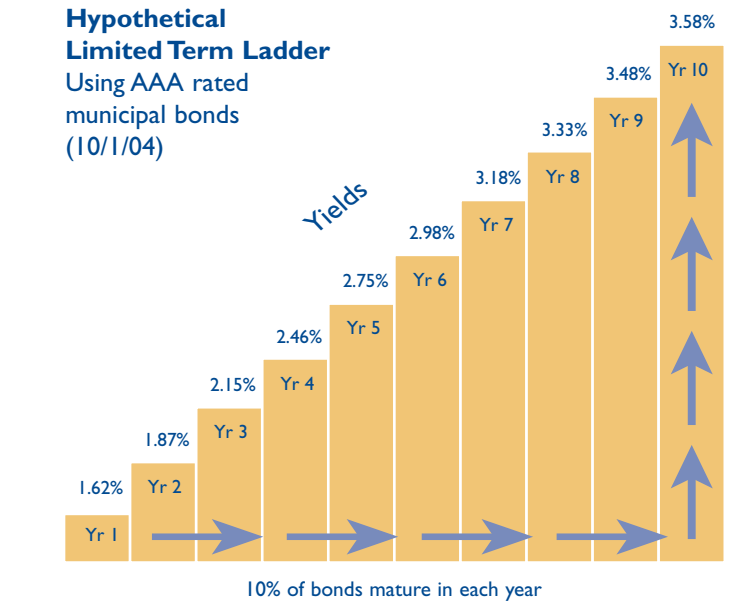
This year has certainly been no exception. For most of the year, bond traders have been focused on the non-farm payroll employment number as an indicator of economic strength. In February, after posting a 3-month average of only 83,000 new jobs, all the talk was of the

“jobless recovery.” Expectations were therefore very low when the Bureau of Labor Statistics reported 353,000 new jobs in March. Bond yields rose dramatically in April and May while forecasters ramped up expectations to 200,000 plus new jobs per month. That’s when the June and July numbers came in below 100,000 jobs and bond yields plummeted back down toward their lows. Many people have been surprised at how wrong the collective wisdom of so many brilliant minds can be. A recent study conducted by Goldman Sachs sheds some light on the difficulties of forecasting job growth. They conclude that the average non-farm payroll number over the last 8½ years was 113,000 new jobs, while the average consensus forecasting error was almost 100,000 jobs.

So the bottom line is this: *beware of forecasts and be prepared for the unexpected!*

How does one prepare for the unexpected? By using flexible investment strategies that react to changing conditions and deliver good results *in all market conditions*.

Most investment strategies are designed to perform well under a given set of assumptions. In fixed income, many of those assumptions revolve around the shape of the yield curve and the direction of rates. To add value,



portfolio managers often develop a theory about future interest rates and implement strategies to optimize returns under those assumptions.

However, as we documented above, it is very difficult to accurately predict the direction, magnitude, and timing of interest rate movements. If the manager guesses incorrectly, serious repercussions may result. For instance, a long duration strategy can produce a 15% principal loss in a short amount of time if long-term interest rates rise 1%. Conversely, going to cash will lead to opportunity cost (from less income and foregone capital gains) if interest rates fall. Barbell (combining short and long maturities) has been popular of late, but it works best only when the yield curve flattens significantly. It typically underperforms other intermediate strategies if the yield curve moves in a parallel or steepening fashion.

Thornburg has chosen to use laddering because it is an all weather strategy that has distinct advantages over other bond strategies. What follows is a brief discussion of what we believe to be the three principal advantages of laddering.

1. Yield advantage: A typical Thornburg limited term bond ladder will consist of bonds that mature from 1 to 10 years. When the ladder is first assembled, one must buy 10% one-year bonds, 10% two-year bonds, etc., out to 10% ten-year bonds. The average yield of the portfolio will be a blended yield of all the bonds in the ladder – in the example at right, 2.74%. However, the portfolio yield doesn’t stay there. If we assume constant interest rates, the portfolio yield will climb every year for nine years. Why? Because the lowest yielding bonds at the bottom of the ladder will mature and be replaced by higher yielding bonds at the top. For

instance, after one year, the bottom rung of the ladder, yielding 1.62% will mature, and be replaced by a new group of ten-year bonds yielding 3.58%. Even though interest rates did not change, the yield on 10% of the portfolio just went up by 196 bps. If you take this process to its logical conclusion, your laddered portfolio will end up with *the yield of a 10-year bond, but a risk profile more like a 5-year bond.*

2. Price advantage: The front end of the yield curve is almost always the steepest part of the curve. That means that three-year bonds yield significantly less than five-year bonds, which yield less than seven-year bonds, etc. A Thornburg bond ladder typically involves buying bonds and holding on to

them for years. If one holds a bond that was originally purchased as a seven-year bond for two years, it becomes a five-year bond. If interest rates are constant, that bond, which was originally bought to yield 3.18% (see example above), will be priced to yield 2.75%. If one prices a 3.18% bond to yield 2.75%, then the bond's price must go up by 1.98%. In this way, *a bond ladder is able to capture price appreciation as bonds in the ladder age and move closer to maturity.* This happens even though we assume interest rates don't move at all. If interest rates rise, the same effect can work to accelerate the price recovery of one's bond portfolio.

3. Risk control: Since a laddered portfolio spreads bond

maturities over multiple years, only a small portion of your portfolio (10% in the example above) will mature over any one period. In other words, you only have to reinvest a fraction of your portfolio at one time. If interest rates happen to be very low, you can retain the higher yield on most of your portfolio through that period. Conversely, if interest rates are high, you do have some maturing bonds to reinvest into the higher yields. The key is that your reinvestment process is controlled and your portfolio yield should change only gradually over time. Many people consider bond laddering to be a method of dollar-cost averaging into the bond market. This is because it *limits the risk of timing the market poorly when you build and maintain a bond portfolio.*

These advantages work to benefit a laddered portfolio whether interest rates go up, down, or sideways. Individual investors and investment professionals have a consistently spotty record of timing the market and predicting future interest rates. That is why we believe laddering is the best strategy for risk-averse investors who believe it is important to be prepared for the unexpected.