



The Rennie Quarterly Return

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Bonds – Downside Risk

Interest rates are low, lower than they have been since the early '60s. While they could go lower, it seems more likely that the next trend will be upward. Since rising interest rates beget lower bond prices, many bond investors worry how their bond portfolios and mutual funds will perform.

Recently, some "experts" in the news media have made statements suggesting that bonds should not be held at this time given the notion of rising interest rates. They discount the millions of older investors who simply must own bonds because of the safety and stability they provide. This Newsletter takes a more rigorous look at the safety and stability of bonds as well as their potential returns in a rising rate environment.

Safety & Stability

The U.S. Government Intermediate-Term Bond Index data is used herein as a proxy for bonds in general; data were obtained from the Ibbotson SBBI Yearbook. Since 1926, bonds have produced negative annual rates-of-return only nine times, and seven of those were between 0.0% and -2.0%. The worst annual return ever was -4.5% in 1994.

The worst sustained period of rising interest rates began in 1977. From 6.0% at the end of 1976, interest rates rose steadily finally hitting a high of 14.0% at the end of 1981. During this period, annual bond returns were never negative. The cumulative bond return over this five-year period was 24.2%. By 1986, interest rates just about returned to the 1976 level. The cumulative return over the

1982-1986 period was 119%. A word of caution: in the periods discussed above, interest rates were much higher than the present. So, while the pattern of returns will probably hold if interest rates rise going forward, the levels of returns will be lower.

Future Returns.

To simulate returns going forward, we constructed a bond portfolio consisting of five bonds with maturities of 1, 2,

- Scenario 3: Rates rise by 1%/year for five years; then remain steady

In Scenario 1, the portfolio experiences a constant annual return of 3.0%, and a cumulative return of 33.9%.

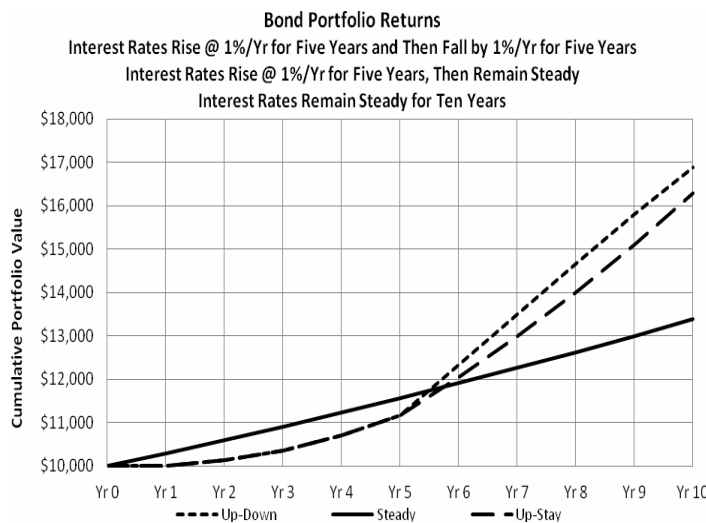
In Scenario 2, returns are lower than Scenario 1 returns for almost four years—as expected. Thereafter, they strengthen; annualized return for the total period is 5.4%, cumulative return is 68.8%

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3, 5 and 10 years. At the beginning of the simulation period, the assumed interest rates (coupons) on each were 0.5%, 1.0%, 1.5%, 2.5% and 4.0% respectively, somewhat close to existing market rates. At the end of each year of the simulation, all bonds were sold at current market prices and new ones were purchased with the original maturities.

Rates-of-return for three scenarios were computed:

- Scenario 1: No change
- Scenario 2: Rates rise for by 1%/year for five years; then return to the starting point in the next five years

While Scenario 3 is quite different from Scenario 2, the ten-year results are quite similar: annualized 5.0%, cumulative 62.9%.

While real-world bond portfolios and mutual funds hold hundreds of bonds of different types, those with average maturities somewhat like the portfolio simulated herein are likely to experience returns consistent with the patterns shown. Not too worrisome, really.



Our Two

Sometimes words can serve me well and sometimes words can go to hell for all that they do.

Harry Chapin



Quarterly Trivia:

What state is the corporate headquarters capital of the United States?

Delaware