Triweekly Series

Ideas and Nuggets of News *You Can Use!*

LINDNER INSIGHTS

More Certainty for Uncertain Times

"Doubt is not a pleasant condition, but certainty is absurd."

Voltaire

A Registered Investment Advisor

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"Big enough to deliver, small enough to care"

by Chris Briggs, CFP®

More Certainty for Uncertain Times

As we continue in the current economic expansion, now 9 years old, it makes sense to revisit our discussion on setting proper expectations. In our November 7, 2016, issue of Triweekly "The Importance of Setting Expectations," I point out the importance of discussing the market's ups and downs before they happen. Most of you use Riskalyze as a tool to explain a portfolio's standard deviation to your clients. The risk assessment and the Investment Policy Statement show the client the potential volatility (standard deviation) with the asset allocation you have chosen (in any rolling 6 month period). The IPS shows a range of returns that encompass 95% of all probable outcomes for the rolling periods.

The issue is not your client's honesty in answering the risk questions or agreeing to the outcome. The problem is that they are humans that can suffer from recency bias. Wikinvest defines Recency Bias or The Party Effect as how "stock market participants evaluate their portfolio performance based on recent results or on their perspective of recent results and make incorrect conclusions that ultimately lead to incorrect decisions about how the stock market behaves."[1] I think you know what I am getting at here. If they have experienced a number of years of good performance, they will likely anticipate this experience to continue. Asset classes that performed well in the last couple years are not as likely to repeat that performance in the near future. The first six months of this year has certainly reminded us all of this fact, as well as the potential for bonds to experience volatility too.

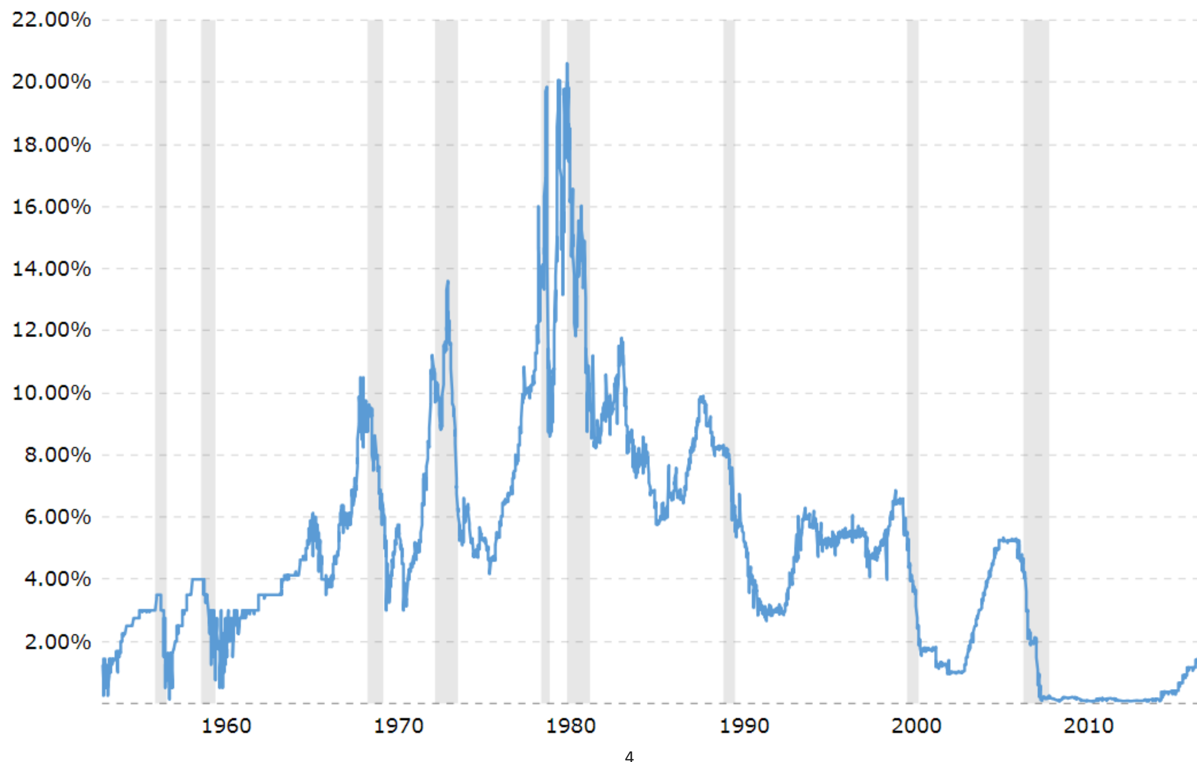
In our first Triweekly issue of 2017, "The Rising Tides of Interest Rates," we address the influence of rising interest rates on bond prices (Bond prices move in the opposite direction of interest rates). Interest rates are directly influenced by the Fed Funds Rate, which is set by the Federal Reserve. This is accomplished by raising or lowering the rate at which banks can borrow from the Fed. Banks then pass higher or lower rates through to customers. The bonds investors hold in portfolios are issued with this cost of funds in mind. Basically all forms of borrowing, bonds included, have some connection to the interest charged or earned, and the Fed Funds rate.

Shortly after the financial crisis began to cripple the US economy in 2008, the Federal Reserve lowered the funds rate to 0%. It stayed at 0% until December 2015, when the Fed began to slowly raise rates. On July 8, 2016, the yield on the 10 year Treasury bond reached an all-time (intermonth) low of 1.36%, meaning a near all-time high for 10 year bond prices. The Fed funds rate is now 2%, and the 10 year Treasury is yielding 2.84% (as of July 5, 2018). The Federal Reserve Bank of St. Louis publishes projections of the Fed Funds rate, and their current projections are a Fed Funds rate of 3.4% by 2020[2], an increase of 70%. How much impact could an immediate rise in rates have on a fixed income portfolio? If interest rates on 10 year treasuries were to "immediately increase from 2.5% to the "100-year" average rate of

[1] http://www.wikinvest.com/wiki/Recency_bias
[2] https://fred.stlouisfed.org/series/FEDTARMD

4.9%; holders of new bonds would see a price decrease of almost 20%."[3] That would represent a dramatic move up in rates, but remember 10 year rates are roughly 2.84% and were at 1.36% just 2 years ago.

This chart shows the history of the Fedreral Funds Rate back to 1954.



[4]

Short term rates have risen more quickly than that of the 10 year bond. Many people, myself included, believe this is an early sign of the economy slowing. A steep yield curve, where short term rates are materially lower than long term rates, indicates a strong demand for credit and a strong economy. The "flatter" the yield curve becomes, and especially if it inverts (short term rates being higher than long term rates), indicates the economy is slowing and may even contract. The Fed raises rates to slow economic growth and it almost always works, sometimes too well.

As you know, our primary focus, at LCA, is on Strategic Asset Allocation. We employ regular rebalancing for most of our strategies. Rebalancing portfolios, as a discipline, benefits our investors through regular profit taking and committing some of those profits to assets that have yet to perform or are currently underperforming. All that said, we recognize most people feel differently about volatility in fixed income holdings.

In response to the changing fixed income outlook, the portfolio management team recently added the Cavalier Hedged High Income Fund to most of our traditional models. The fund has a higher yield than

[3] http://observationsandnotes.blogspot.com/2010/11/100-years-of-bond-interest-rate-history.html
[4] http://www.macrotrends.net/2015/fed-funds-rate-historical-chart

our other fixed income holdings, and the manager has the ability to hedge the portfolio protecting it from some of the potential downside volatility.

In addition to the changes to our Traditional models, we are also now offering laddered bond portfolios for larger accounts. A bond ladder is a portfolio of fixed income securities in which each security has a significantly different maturity date. The purpose of purchasing several smaller bonds with different maturity dates rather than one large bond with a single maturity date is to minimize interest-rate risk, increase liquidity and diversify credit risk. Bond ladders can offer fixed income investors a more certain outcome than bond funds as the worst case return scenario (assuming the issuer does not default) is known at the time of purchase. Portfolios with bonds continuing to mature over time allows the investor to take advantage of new fixed income opportunities when they reinvest.

My colleagues and I, here at LCA, are consistently looking for ways to improve your client's investment experience. The portfolio changes we have made and the addition of the High Income, Diversifier and Bond Ladder strategies give you the solution set you need to deliver your clients a top quality investment experience. Thank you for your continued confidence in Lindner Capital Advisors.

About LCA...

Lindner Capital Advisors, Inc. is a federally Registered Investment Advisor based in suburban Atlanta, Georgia, with representation throughout the United States. Our investment platform provides access to institutional fund strategies and exclusive money managers that are not readily available to the retail market. Our portfolios are designed to be consistent with a client's unique investment objectives, individual time horizon, and tolerance for risk. LCA has been CEFEX certified since 2006 and is committed to our fiduciary responsibility.

Ask your Relationship Manager for a copy of "The Educated Investor" written by Robert Lindner.

For more information, call (770) 977-7779 or email portfolios@LindnerCapital.com.

Visit LCA's website at www.LindnerCapital.com

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