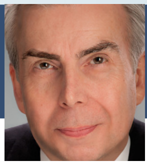
View from the Hill

November 2014

Predicting Curve Balls



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PROFESSIONAL FINANCIAL
Consultative Wealth Management

There's a conventional school of thinking that believes the best way to manage a fixed income portfolio is to base your investment decisions on where you think interest rates are headed. But what if expectations are changing all the time?

Market expectations about interest rates change quickly in response to news. That makes building coherent and profitable portfolio strategies around market forecasts very difficult.

In an article a couple months back, *Bloomberg News* noted that the rally in the US Treasury market in 2014 was stronger than every economist surveyed by its journalists had predicted.[1]

US 10-year yields were around 2.3% at the end of August, down from just over 3% at the end of 2013. They dropped briefly to 1.9% in mid-October and are back to 2.3%. Yields fall as prices rise, so those who heeded economists' forecasts and backed out of bonds missed part of this capital return.

But this isn't just a US story. Japan's 10-year government bond yield hit its lowest levels in 16 months in late August, then rose briefly, and then declined even lower. European bond yields tumbled to record lows, and declined further when the European Central Bank lowered rates in September.

Why did many economists get their interest rate calls wrong? There could be a variety of reasons. Economic growth and inflation may have been below their assumptions. Geopolitical strains may have dampened risk appetites. Central banks may have adjusted their timetables for withdrawing monetary stimulus.

The important point is that unless you have a way of forecasting news, you are unlikely to enjoy consistent success in basing your fixed income strategy on anticipating changes in interest rates.

Luckily, there is another way of managing fixed income, one that doesn't require predicting interest rates. It involves diversifying globally and using the information in the market at any one time to work out which parts of the market to invest in.

The benefits of diversification come from the fact that interest rate cycles can vary across economies, reflecting differences in expectations for inflation, economic growth and other indicators.

For example, while benchmark rates in many economies remain at record lows, New Zealand raised its cash rate four times since March. Elsewhere, while markets anticipate the Bank of England raising rates. The European Central Bank's September announcement for further stimulus to ward off deflation was a surprise, and the Japanese Central Bank announced their own surprise stimulus only days ago.

The non-correlated nature of interest rate movements implies that spreading fixed income risk globally can reduce volatility in an overall portfolio. This is the argument for global diversification—not betting everything on a single market.

1. "Treasury Market Rally Stronger than Every Economist Predicted," *Bloomberg*, August 30, 2014.

The second part of this non-forecasting approach is to vary maturities in a portfolio depending on the state of the yield curve today. The yield curve is a graph that compares the yields of similar sorts of bonds of different maturities.

A normally sloped yield curve is upward sloping—reflecting the additional return investors require for committing their capital for longer periods. This is called "term risk." Sometimes, yield curves can flatten or invert. This is when there is little or no premium on offer for tying up your money for longer periods.

So if the yield curve is upward sloping, it may pay to take more of this term risk because you are being compensated for it. Conversely, if the curve is flat or inverted, there is little or no compensation for taking on the term risk, so you may stay in shorter-dated bonds.

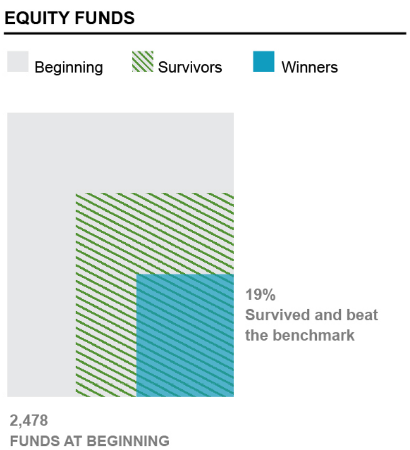
This approach uses no forecasting, market timing, or assumptions about the direction of interest rates. It uses today's yield curve to work out where to allocate term risk in a portfolio. And treating bonds as a global asset class provides a larger set of yield curves to choose from—more opportunity, more diversification.

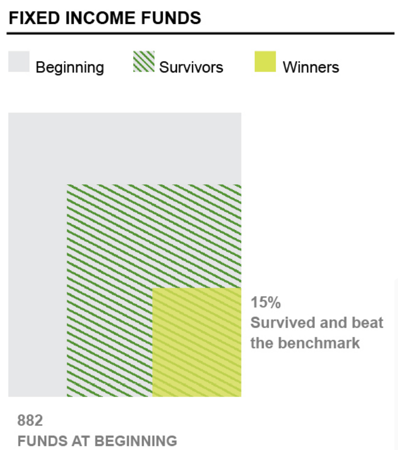
Dimensional uses today's market prices to form efficient strategies based on the information that is already out there. There is significant evidence that correctly forecasting interest rates with any consistency is impossible. But we can seek to control exposure to risk, cost and diversification.

Of course, almost every economist, media expert or financial advisor somewhere has an opinion about the interest rate outlook. That's fine. The problems arise when we base long-term investment decisions on expectations for interest rates, only to see them confounded by the curveball of new information.

OUTSMARTING OTHER INVESTORS IS TOUGH

Few mutual funds survive and beat their benchmarks | 10-year performance period ending December 31, 2013





Beginning sample includes funds as of the beginning of the 10-year period ending in 2012. The number of funds as of the beginning is indicated below the exhibit. Survivors are funds that are still in existence as of December 2012. Winners are funds that survive and beat their respective benchmarks over the period, as indicated by Success Rate. Funds are identified using Lipper fund classification codes and are matched to their respective benchmarks at the beginning of the sample period. Loser funds are funds that did not survive the period or whose cumulative return did not exceed their respective benchmark.

Source: Mutual fund data is from the CRSP Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago.

If you are a successful professional, physician or retiree, contact us about our complimentary "Second Opinion Service." Our ebook, Selecting the Right Advisor, *is available free upon request.*