

REPORT

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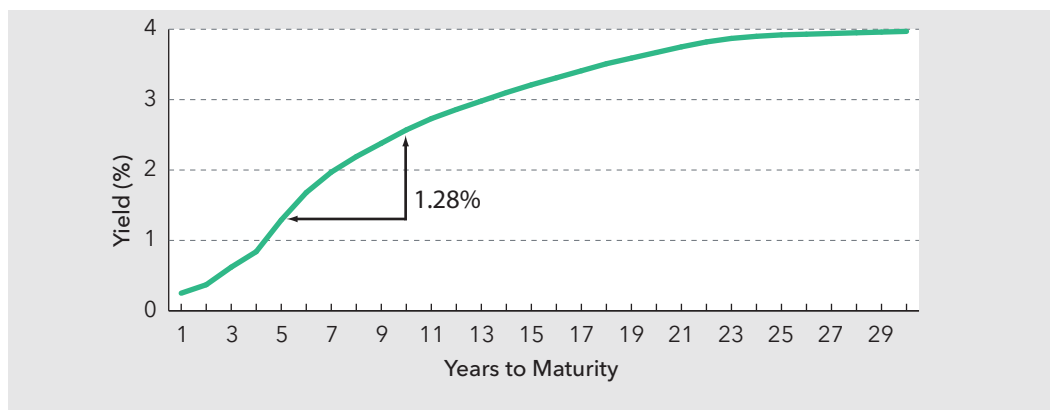
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Fixed Income Investing When the Yield Curve is Steep

WHAT DOES IT MEAN TO SAY THE YIELD CURVE IS STEEP?

The yield curve is a graphical representation of the relationship between yields and maturity. Under normal market conditions, the curve slopes upward from left to right with higher yields on bonds with longer maturities. This reflects the fact that the holder of longer-term bonds may face more credit and interest rate risk. A steep yield curve simply means that there is an unusually large difference between the yields on bonds with long maturities and the yields on bonds with short maturities. In general, the greater the difference between yields of short and long maturities, the steeper the slope. The chart below shows the yield curve as of 7/30/10 for AAA-rated general obligation municipal bonds.

AAA-Rated G.O. Yield Curve as of 7/30/10



Source: Thomson Reuters MMD.

IS TODAY'S YIELD CURVE STEEPER THAN USUAL?

Yes. To illustrate what has been happening in the municipal bond market, I want to refer to the yields of general obligation bonds rated AAA, as reported by Thomson Reuters in their MMD scale. Over the last ten years, the average spread between yields on 10-year bonds and yields on 5-year bonds has been 0.74%. As of the end of July, however, that difference was 1.28%.



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Market commentators are talking about the yield curve being especially steep right now. Here Cadmus Hicks provides answers to some common questions about the state of the yield curve and what that might mean for investors.

WHAT DOES A STEEP YIELD CURVE USUALLY MEAN FOR FIXED INCOME INVESTORS?

The most obvious symptom of today's steep yield curve is the low rate of return being paid by money market funds.¹ As a result, in 2009, assets of money market funds shrank by 18.9% in large part due to withdrawals, and in the first half of 2010 they dropped by another 15.2%.²

In this type of environment, the average investor is motivated to seek enhanced yields, potentially through the purchase of bonds with longer term maturities. Investors may potentially further enhance their returns through capital appreciation of these longer term bonds, if there is no change in interest rates, because of the effect of "rolling down the yield curve."

HOW DOES "ROLLING DOWN THE YIELD CURVE" WORK?

If interest rates do not change, and bonds with shorter maturities have lower yields than longer-term bonds, then the yield that is used to set the price of a bond will decrease over time as that bond has less time until maturity. Lowering the yield of a bond with a fixed coupon rate raises the price. For example, suppose an investor bought XYZ bond due in 10 years that yields 2.79% at a time when other bonds due in 9 years yield 2.62%. If interest rates stay the same, a year from now that XYZ bond would be priced to yield 2.62% because it would then have 9 years to maturity; it would have rolled down the curve by one year. Pricing the bond to yield 2.62% would produce capital appreciation of 1.36% in addition to the yield of 2.79%, for a total return of 4.15%.

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DOES THIS STRATEGY APPLY TO TAXABLE AND TAX-EXEMPT BONDS?

While the municipal yield curve tends to be steeper than the Treasury curve, this strategy can also be used by investors in the taxable market.³ In a recent interview, Bill Gross of PIMCO discussed rolling down the yield curve. He said, "To the extent that this 'extended period' of time stays with us for two to three years, then this roll down curve strategy for Treasuries or for corporates can add ... to the bottom line."⁴

When he spoke of this "extended period," he was referring to the fact that the Federal Reserve's Open Market Committee has stated repeatedly that, "Economic conditions... are likely to warrant exceptionally low levels of the federal funds rate for an extended period."⁵ A low fed funds rate tends to keep interest rates low at the short end of the yield curve, which also tends to keep the yield curve steep, enhancing the roll down strategy.

WHAT HAPPENS IF THE FED INCREASES THE FED FUNDS RATE?

Yields of all maturities usually increase when the Fed raises the fed funds rate, but the increases tend to be greater for shorter maturities. For a given increase in interest rates, bonds with shorter maturities generally experience less of a decline in market value than bonds with longer maturities

1 *The Wall Street Journal*, p. C4, August 13, 2010.

2 Federal Reserve Flow of Funds and the Investment Company Institute.

3 Source: Bloomberg. Typically, yields of bonds in the corporate market are quoted as a spread over Treasuries of the same maturity and, in general, they have similar yield curves. For the 10 years ending 6/30/2010, the average spread between 5- and 10-year Treasuries was 0.62%, while the average spread between 5- and 10-year bonds on the MMD scale was 0.74%.

4 Bloomberg Radio's "On The Economy" interview with Tom Keene, July 28, 2010.

5 <http://www.federalreserve.gov/fomc/>. This language has been included in every meeting held in 2010: January 26-27, March 16, April 27-28, June 22-23 and August 10.

(because shorter maturities usually mean shorter durations and less price volatility). However, if the yield curve flattens (short-term rates rise more than long-term rates) the greater increase in yields could offset to some extent the advantage provided by the shorter bond's lower price volatility. Thus, staying in very short maturities may not provide the advantage one expected.

Furthermore, the fact that bonds roll down the yield curve means that there is some room for shorter-term yields to rise before they exceed the yield at which the bond was originally bought. However, there is one big caveat in capturing these changes in price: the bonds can't be held all the way to maturity. If you buy and hold to maturity, the price will eventually move back to par.

Investors who buy and hold bonds until maturity usually ignore the changes in price brought about by the roll and therefore potentially give up on growing principal in their bonds over time. Usually there is a point in time where it makes sense to sell the existing bond and reinvest the proceeds into new, longer bonds, reestablishing the original maturity target. However, this is difficult to do in the retail market (ie, less than \$1.0 million par amount) due to transaction costs. Institutional money managers work to reduce these costs by typically trading much larger blocks of bonds.

IF THE FED IS EXPECTED TO RAISE THE FED FUNDS RATE EVENTUALLY, SHOULD THOSE ALREADY INVESTED IN MONEY MARKET FUNDS REMAIN THERE, DESPITE THE LOW YIELDS?

For the fixed income investor, the problem with keeping investment dollars in money market funds is that we do not know how long this "extended period" will last. The longer an investor has to wait for higher yields, the greater the opportunity cost for not having invested in longer-term bonds, and the higher future yields would have to be in order for two short-term investments, purchased sequentially, to produce a higher return than that of a single longer-term bond bought today.

PROVIDE AN EXAMPLE OF ROLLING DOWN THE YIELD CURVE.

As of 6/30/10, 10-year, noncallable, AAA rated general obligation bonds were yielding 2.79%, and 9-year bonds were yielding 2.62%.⁶ Suppose you bought a noncallable 10-year bond on 6/30/10 with a coupon of 2.75%, a yield of 2.79%, and a dollar price of \$99.65 . If interest rates did not change, a year later, that bond would be priced to yield 2.62%, which would produce a dollar price of \$101.04. (Some of the appreciation represents accretion, or accumulated value, of the discount rather than change in yield.) On an investment of \$99,650, the total return over the period would be the appreciation of the bond, plus the coupon earned (ignoring compounding) divided by the initial investment:

Appreciation	\$1,390 = \$101,040 - \$99,650
Coupon	2,750
Return	\$4,140

$\$ 4,140 / \$ 99,650 = 0.0415$, for a rate of return of 4.15%.

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⁶ Source: Thomson Reuters MMD.

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