polaris Wealth Advisers, LLC

Polaris Educational Series

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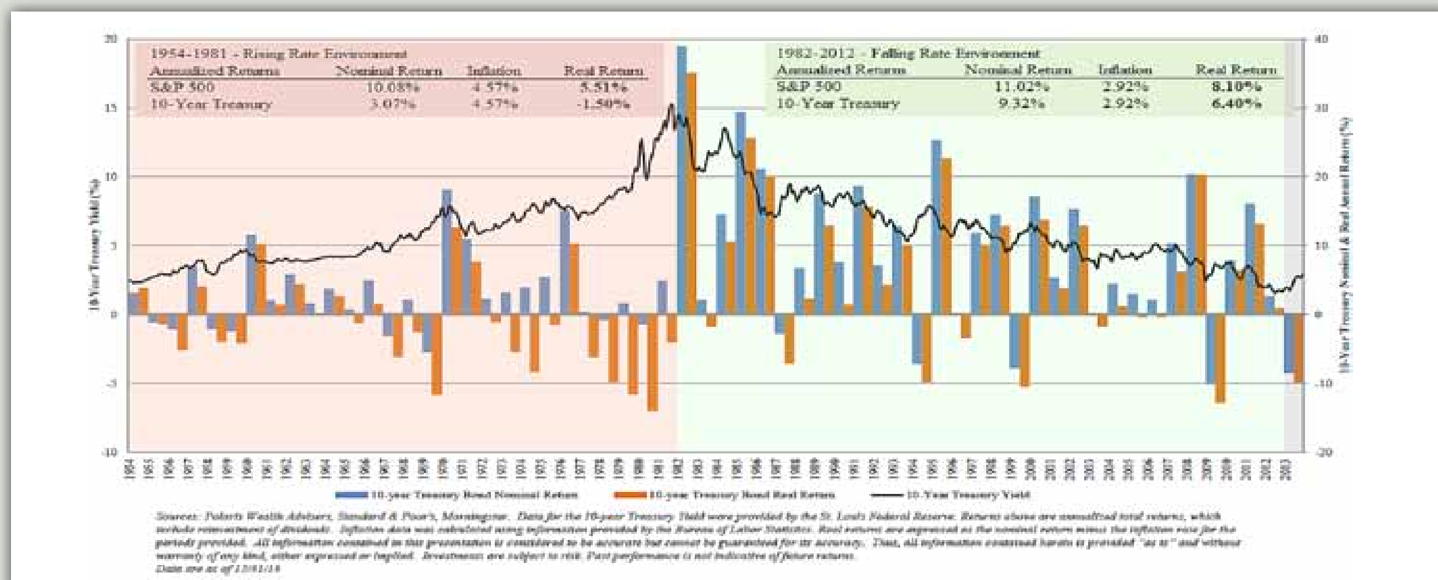
Real Returns in a Rising Interest Rate Environment

I am a strong believer in understanding history. Today's e-mail is a history lesson on how historical interest rate movements have affected portfolio returns. The results may make you rethink your portfolio asset allocation.

In order to understand this history lesson, I need to explain some technical terminology (sorry, there is no way around it in this case). The nominal return of an investment is calculated by taking the income (dividends for stocks, interest payments for bonds) and then either adding or subtracting price changes in the investment. Stock prices change based upon what the perceived value of the underlying company is worth today, and future expectations of it tomorrow. The price of a bond typically reacts in the exact opposite direction as interest rates. Think of bonds like a see-saw with price on one side and interest rates on the other. As interest rates rise, bond prices typically drop. Conversely, if rates drop, prices typically go up. The more interest rates change, the more price changes. The bond's maturity date also affects the movement (with long-term bonds changing more than short-term bonds). The last term I have to define is the real return. The real return is calculated by taking the nominal return and subtracting inflation.

From 1954 until September 1981, a 27-year period, interest rates gradually rose in the United States. The 10-Year Treasury's yield grew from less than 3% to over 15% in the midst of the hyper-inflation our country experienced in the late 70s and early 80s. The impact that this had was a very low nominal rate of return for the 10-Year Treasury and a negative real return. Inflation also ate away at the real return for stocks. If you were invested in only 10-Year Treasury Bonds, you would have received a nominal return of 3.07% annually, and a real return of -1.50%. Even though your portfolio might have grown by a meager 3% per year, you would have lost buying power. The S&P 500 had a 10.08% nominal return, but after inflation had a 5.51% real return. If you split your portfolio evenly between the two, you would have received a real return of 2.01% per year.



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Most investors with whom we work learned how to invest in the 80s and 90s. They were told to invest in a balanced portfolio of stocks and bonds, which would provide them both protection and growth. From 1982 to 2012, a 30-year period, this advice provided an 11.02% nominal return for the S&P 500 and a 9.32% nominal return for the 10-Year Treasury. Inflation remained low at 2.92% on average, providing very high real returns. An investor invested in the 10-Year Treasury received a 6.40% real return. A better real return than an investor in the S&P 500 during the rising interest environment discussed above! The S&P 500 gained even more, providing a real return of 8.10% on an average annual basis. If you evenly split your portfolio between the two, you grew your portfolio 7.25% annually after inflation.

2013 was a fantastic year for stocks, returning 32.39% on a nominal basis. The 10-Year Treasury on the other hand, had one of its worst years in decades, losing 9.95%. The 10-Year Treasury's negative performance was largely due to a tightening monetary policy in Washington D.C., making borrowing more expensive. The impact on a balanced portfolio was felt by most investors. A balanced portfolio of 50% S&P 500 stocks and 50% 10-Year Treasuries only had an 11.22% nominal return and a 9.77% real return after inflation.

As we've discussed at length in prior educational e-mails, the United States is between a rock and a hard place. 50% of our more than $17 trillion national debt is in treasuries with maturities less than two years. Our debt costs the country more than $250 billion in spending each year. While Fed Funds rates remain at essentially 0%, they can only remain this low for a limited time. At some point, rates will have to rise, negatively impacting bond prices and causing our deficit to skyrocket. At the very least, rates will remain at historically very low levels, suppressing bond returns and those in equally balanced stock-to-bond portfolios.

As you know, Polaris manages money in a dynamic manner. We lower our exposure to the stock market when we feel that risk outweighs possible future returns. We have historically been able to protect our clients from the full extent of the major pull backs in the stock market using this technique. And while no one can promise future results, we hope to repeat our success of protecting our clients from the full downside in the stock market. With this in mind, please ask yourself this question: Can you stomach a one or two year downturn in the stock market at any given point in the future or do you risk experiencing the possibility of several decades of below average returns in the bond market?

I would encourage each and every one of you to truly consider the very strong possibility of very low bond returns for an extended time period into the future. What impact would that have on your portfolio given your current allocation? What impact might this have on you accomplishing your financial goals? There are ways that we can combat this impact. Please feel free to write me or discuss our strategies with your adviser at Polaris.

As always, I look forward to your comments and questions.

Sincerely,

Jeff