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Perspective on Potential Interest Rate Increases

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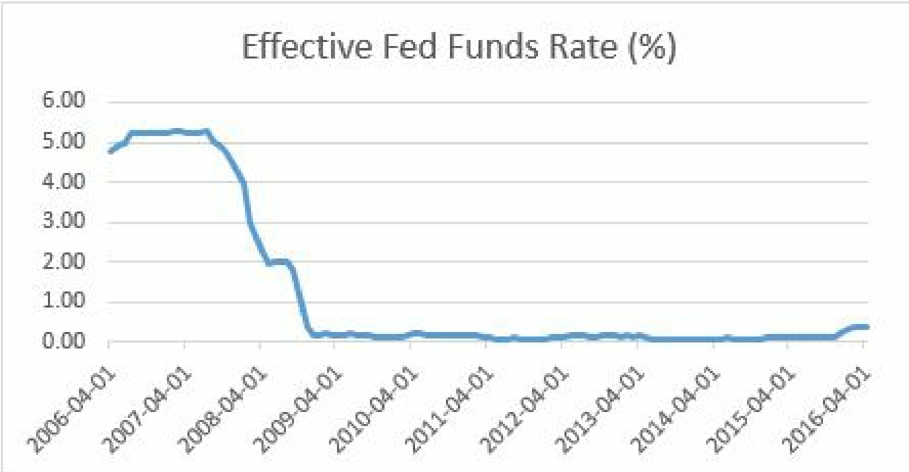
In its perpetual quest to feed the insatiable 24/7 news cycle, the financial media has once again latched onto the uncertainty over next steps for the Federal Reserve as it evaluates potential interest rate increases. Reminiscent of late last year, when the Federal Reserve raised the fed funds target rate for the first time since 2006, dire predictions abound for investors should the Fed make a policy misstep. While we agree that Fed policy does have important implications for investors, and uncertainty about the Fed's next move could be contributing to market volatility, we want to take a step back and provide a balanced assessment of the situation.

Let us start with a brief refresher on the fed funds rate and what it means to investors. The fed funds rate is one of the Federal Reserve's key tools in pursuing its dual mandate of price stability and maximum employment. By changing the fed funds rate-the interest rate charged to commercial banks and other institutions-the Fed is able to directly adjust the cost of funding for banks and indirectly affect short term interest rates throughout the financial system, such as mortgage rates and interest rates on deposits and credit cards. The Fed has consistently kept rates low since 2008 which means borrowing costs remain low and banks are incentivized to lend. This lending activity induces increased investment by companies and individuals. In addition, based on the low return from conservative investments such as bonds, investors are pushed out on the "risk spectrum" into more volatile assets such as higher yielding bonds or dividend paying stocks in order to capture the same amount of yield they used to receive. On the flip side, increasing interest rates raises borrowing costs and may slow economic activity by reducing business and personal investment. Increased interest rates also make less risky investments such as bonds more attractive, which in turn also slows demand for riskier investments and may lead to more savings over spending.

The chart below illustrates the fed funds effective rate over the past ten years. We think there are two important aspects to note: first, that the fed funds rate has been held at essentially zero since 2008-which is an unprecedented period for such extremely low rates. Second, while much ado has been made regarding the initial rate hike in December and potential additional rate hikes this year, the fed funds rate itself remains historically quite low. While the direction of monetary policy is tighter-or less conducive to economic activity-the policy nonetheless remains very accommodative and should continue to support growth.



Data supplied by Federal Reserve Bank of St. Louis Economic Research

Admittedly, there are valid reasons to be concerned over aggressive rate hikes and their consequences for both bond and stock investors. A rate increase might hurt bond investors because the price of bonds moves inversely to interest rates. In other words, as interest rates rise, investors holding bonds might experience losses on the value of their current bond holdings. Depending on the severity of the rate increase and bond price reaction, the loss might exceed the coupon or interest payment substantially, resulting in negative total returns.

A rate increase may also hurt stock investors, albeit through more varied and less direct avenues. One conventional effect on stock investors occurs when the general growth in the economy slows down due to the increased rates which will ultimately affect company valuations. There may also be a more technical risk for stock investors as rates rise from historic lows: a wholesale retreat by investors along the risk spectrum. This means that an income-oriented investor that may traditionally have held safer bonds has been forced to look to riskier bonds, or even riskier dividend yielding stocks. As rates on bonds normalize to more traditional levels, investors might sell riskier assets such as stocks and rotate back into bonds, creating selling pressure and volatility within markets.

These concerns are valid and our intent is not to cast a blind eye to real risks in the marketplace. However, for long-term investors with appropriately diversified portfolios, we see no need to panic. In fact, we believe there are two positive aspects associated with potential rate rises that seem to be consistently overlooked.

The first is simply a view of why the Fed is contemplating a rate increase in the first place: that they (some of the best pedigreed economists in the country) believe the US economy is strong enough to not only withstand but in fact requires higher interest rates! Their assessment of the economy suggests that it has recovered from the financial crisis nearly eight years ago and no longer needs life support vis-à-vis incredible monetary stimulus. Surely a logical investor if given a choice would prefer an economy strong enough to stand on its own to a market propped up by extraordinary monetary policy.

To support this view, we studied the last five Fed rate hikes, going back to the early 1980's. The table below shows the date of the first Fed hike entering a new policy regime, and the ensuing 12-month return for the S&P 500. While returns were often volatile following the initial hike (as we have witnessed since the December move), we note the historical tendency for the stock market to be positive over the year after a hike. Of course we must recognize that past is not necessarily prologue and historical performance is not indicative of future results, but nonetheless the data caught our eye.

Date of 1st Hike	12-month period	S&P 500 Total Return
February 1983	Mar '83 - Feb '84	+10.9%
December 1986	Jan '87 - Dec '87	+5.2%
January 1994	Feb '94 - Jan '95	+0.5%
May 1999	Jun '99 - May '00	+10.5%
May 2004	Jun '04 - May '05	+8.2%
	Average	+7.1%

Data obtained from Federal Reserve Bank of St. Louis Economic Research and Dimensional Fund Advisors

The second aspect that we think bears mention are the positives for investors, and fixed income investors in particular, that a return to more normal interest rates bring. While we do not dispute the mathematical truth that bond prices fall in response to rising interest rates, higher rates also afford investors the opportunity to repurchase new bonds at better rates.

Take the case of a bond ladder-or a series of bonds with maturity dates diversified over time. As the next bond comes due, if an investor does not have immediate need for the cash, they may roll the proceeds forward into a new "rung" of the ladder and buy a new bond at a higher interest rate than the one that just matured. In this fashion bond portfolios self-adjust over time to new interest rates and, while the adjustment process may be uncomfortable depending on the severity of rate rises, investors who are able to stay committed to their strategy are rewarded with more income in the long run from their portfolio.

We think it appropriate to close with the humble admission that we possess no secret insight into the Fed's thinking or the likely market reaction, and recognize that many of the concerns expressed on the front pages of financial periodicals are rooted in sound logic-if potentially sensationalized to drive circulation. Capital markets do not like uncertainty, and returns could well continue to be volatile as the Fed moves towards normalizing monetary policy. Amid the uncertainty, remember that rising rates are ultimately a sign of conviction in the strength of the economy by the Federal Reserve and, in the long run, all investors are better off in a more normal economy that provides adequate real yields.

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