May 2013

IdahoTrust

WealthManagement

SOLUTIONS FOR YOUR LIFENEEDS™

Market Insights

A periodic newsletter from Idaho Trust

With interest rates and bond yields at rock bottom and the economy showing steady signs of improvement, many investors have been wondering when rates will rise and how the prospect of rising rates will affect their investment portfolios. Bond investors in particular have been wondering what the future holds for their investments especially in a rising interest rate environment.

Rising Interest Rates and Bonds

Bonds and other fixed income instruments are unique because their future cash flows are known, unlike stocks. For example, when an investor buys a bond they know that periodically the bond will pay coupon payments and then repay the principal at maturity. This function of bonds makes them sensitive to current interest rates or more specifically current bond yields. If an investor purchases a bond and a short time later market yields rise and new bonds start to pay higher coupons, the bond that the investor purchased will decline in price because it does not pay as high of coupon payments as bonds that have just been issued. This is a simple example of the inverse relationship that bond prices share with market yields. When yields rise, bond prices decline and vice versa. Bond investors fear rising market yields will negatively affect the performance of their current holdings. Currently, yields are at historic lows and have been for some time leaving investors preparing for a time when the economy is strong enough to cause upward pressure on interest rates and market yields.

The yields that bonds offer depend largely on the characteristics of the bonds themselves. Typically, bonds with longer maturities or lower credit ratings will offer

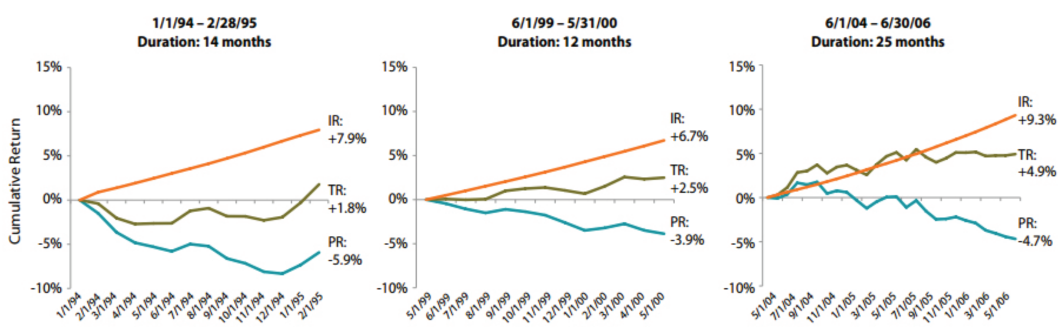
Idaho Trust Bank offers total wealth solutions including its LifeNeeds™ investing process. The LifeNeeds™ investment process utilizes proven strategies and techniques delivered by a highly trained staff of wealth management professionals.

LifeNeeds™ wealth management accounts feature optimized asset allocations, robust security screening and Idaho Trust's unique TacticLogic™ investment process. All of which are tailored to our clients' unique financial needs.

higher yields to entice investors to invest in them. When graphed, these yields create what is called a yield curve, which generally slopes upward as bond maturities get longer. The levels of yields on the short-end of the yield curve are influenced by the rates that the Federal Reserve has set. Conversely, the longer-end of the yield curve is more influenced by the market's inflation expectations, among other things. Yield curves change over time adjusting to new market data both in level and in shape. These changes in yield curves impact bond portfolios' performance.

Because a significant portion of a bond's total return is derived from the income that it provides rather than merely price appreciation, the prospect of a bond bear market is not nearly as severe as a bear stock market. The graphic below shows three examples of Barclays Capital Intermediate Government/Credit Index's returns in rising rates. For all three periods total return (TR) was positive given the positive income return (IR). For stocks

Price Return (PR), Income Return (IR) and Total Return (TR) in Rising Rate Environments



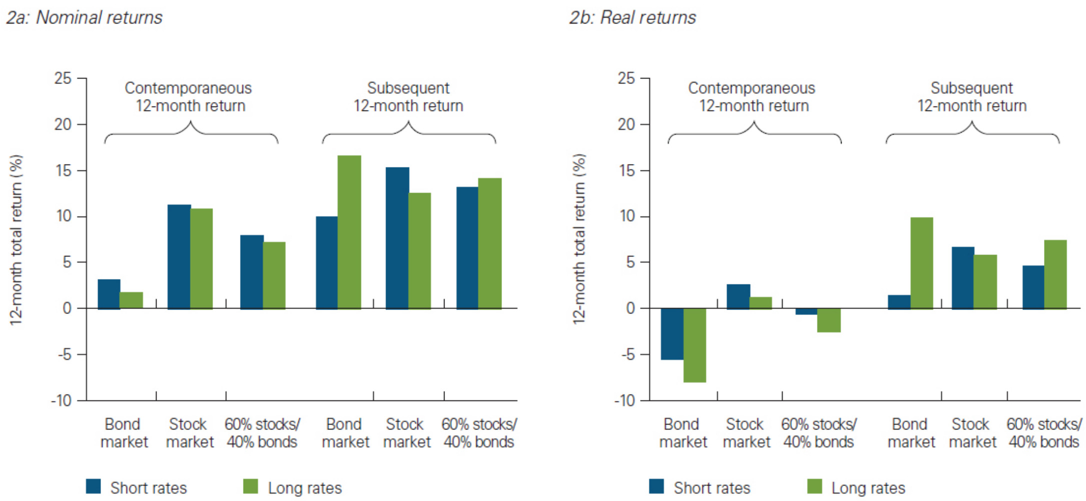
Source: Barclays Capital; Baird Analysis

to be in a bear market it is commonly regarded that the market will have to return -20% or worse. Conversely, the bond market's worst one-year return since 1926 was when the 12-month trailing return for the broad bond market returned -9.2% for period-end March 31, 1980. The worst calendar year returns for bonds was 1994 in which they returned -2.9% which was followed by 1995 when they returned 18.5%. The stock market returned worse than -2.9% in 27 individual trading days alone in 2008.

Historic Examples

History has provided us several examples of bond returns during periods of rising rates. The following figure illustrates a study that analyzed nominal and real returns, adjusted for inflation, to bond, stock and a balanced portfolio during and after either short-term or long-term rate increases of at least 2%. As the findings show, in all periods of rising rates the balanced portfolio returned positive nominal returns and enjoyed significant real returns after the periods of rising rates. These examples help to illustrate that bear markets for bonds are of much less magnitude than bear markets for stocks and that diversified long-term investors can weather rising rate environments and even benefit from rising rates over time.

Figure 2. Average returns to bond, stock, and balanced investors in the United States during and after periods when yields increase at least 200 basis points



Source: Vanguard, using data provided by Thompson Reuters Datastream. To represent short rates, we use the middle rate of the 3-month Treasury-bill traded on the secondary market from 1970 through 1981. For the period since 1981, we use the 90-day constant maturity Treasury bill. To represent long rates, we use the 20-year constant maturity Treasury bill. Inflation is represented by the Consumer Price Index. Bond market returns are represented by the Barclays Capital U.S. Treasury Index starting in 1973. Stock market returns are represented by the MSCI USA Index starting in 1970. The balanced portfolio covers only the periods where returns for both stocks and bonds are available—1973–April 2010. The returns here represent the average return across all periods that saw a 200-basis-point rise in yields. As with any average, some periods saw higher returns and some saw lower returns. For example, returns for the balanced portfolio during periods where short-term rates increased ranged from –0.46% (10th percentile) to 15.72% (90th percentile).

Strategies for Rising Rates

There are a number of options that bond investors can take to help counteract the effect that rising rates have on their bond positions. First, holding a diversified portfolio of different types of bonds can lower overall risk. Holding a diversified portfolio of various bond sectors at varying maturities will help to minimize the exposure to specific rising rates. Diversification to various bond sectors, especially those that pay higher coupon rates than government or government related securities can help. These higher coupons help act as larger buffers to protect the bonds' total returns from price declines. Lastly, active managers may fair better in highly uncertain market environments than passive investments. Active management may be able to identify areas of concern and opportunity to boost total returns or protect principal.

Conclusion

When facing the prospects of rising rates, long-term bond investors need to keep in mind that bear markets for bonds are typically milder than bear markets for stocks. Although rising rates will challenge bond returns, bond holdings will continue to provide vital diversification benefits and eventually pay higher rates of income.

S&P 500 Index

3 Month	7.18%
Year-to-Date	12.73%
1 Year	16.88%
3 Year	12.78%
5 Year	5.21%

MSCI EAFE Net Index

3 Month	5.25%
Year-to-Date	10.82%
1 Year	20.00%
3 Year	8.02%
5 Year	-0.39%

Barclays Aggregate Bond Index

3 Month	1.60%
Year-to-Date	0.89%
1 Year	3.68%
3 Year	5.51%
5 Year	5.72%

As of 4.30.2013

Contact Us

Boise
888 W. Broad St.
Boise, Idaho
208.373.6500

Coeur d'Alene
622 E. Sherman Ave.
Coeur d'Alene, Idaho
208.664.6448

Las Vegas
2850 W. Horizon Ridge PKWY, Ste 200
Henderson, Nevada
702.430.4747

Info@IdahoTrust.com
www.IdahoTrust.com