JANUS

Rising Rates

Challenge and Opportunity

Summary While the prospect of rising interest rates generally strikes fear into the hearts of fixed income investors, it's important to remember that periods of rising rates are normal and can create opportunities for active bond managers. Since 1970 there have been 21 periods in which interest rates rose significantly. While each has had its own unique characteristics, over the past 20 years equities have rallied during these periods, which has tended to support corporate credit markets. Also, interest rates generally rise in a nonlinear fashion that creates opportunity for active investors who have the flexibility to buy and sell during market dips and peaks, minimize exposure to the most rate-sensitive segments of the yield curve, and use individual security selection to benefit from market dislocations.

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Reversing course

There appears to be no greater fear in the hearts of fixed income investors than the prospect of rising interest rates. Over the past few years, unconventional monetary policies by the U.S. Federal Reserve (Fed) have suppressed U.S. Treasury rates to unprecedented lows in an effort to stimulate economic growth.

However, recent U.S. economic data reflects modest acceleration that may give the Fed the support it needs to begin tapering quantitative easing (QE).

Fixed income investors find this worrisome, of course. Reassured by repeated Fed pledges to hold rates down, investors have flocked into the bond market in recent years, driving up prices and sending bond yields —

Exhibit 1

S&P 500 return during previous rising-rate periods

Time period of rising rates*	10-year Treasury yield at start of period	10-year Treasury yield at end of period	Yield change (bp)	S&P 500 cumulative return
March 1971-July 1971	5.38	6.95	+157	+0.07%
November 1971-August 1973	5.72	7.58	+186	+16.75%
December 1973-April 1975	6.68	8.35	+167	-3.10%
December 1976-February 1977	6.80	7.82	+102	-1.21%
June 1979-February 1980	8.76	13.65	+489	+19.47%
June 1980-September 1981	9.47	15.84	+637	+11.70%
November 1981-February 1982	12.92	14.95	+203	-5.47%
May 1982-June 1982	13.46	14.76	+130	-4.86%
May 1983-May 1984	10.12	13.95	+383	-3.89%
April 1986-June 1986	6.95	8.31	+136	+5.89%
December 1986-October 1987	6.92	10.23	+331	+3.87%
March 1988-March 1989	8.11	9.54	+143	+14.50%
December 1991-March 1992	6.69	7.69	+100	+8.62%
October 1993-November 1994	5.17	8.03	+286	+2.15%
January 1996-June 1996	5.52	7.06	+154	+10.10%
October 1998-January 2000	4.16	6.79	+263	+39.44%
October 2001-April 2002	4.18	5.43	+125	+4.26%
June 2003-June 2004	3.11	4.88	+177	+20.63%
June 2005-June 2006	3.88	5.24	+136	+8.35%
December 2008-June 2009	2.06	3.95	+189	+4.26%
October 2010-February 2011	2.38	3.74	+136	+17.27%

Source: Bloomberg, FactSet. Data presented reflects past performance, which is no guarantee of future results.
**From first day of beginning month of the period to final day of ending month of the period.*

which move inversely to price — to record lows. It's important for investors to remember that back-ups in rates are a normal part of a well-functioning economic system and should not signal cause for panic. Going back to 1970, there have been 21 periods during which rates rose significantly. Some key points to consider:

- While each rising-rate period has its own unique characteristics, over the past 20 or so years equities have been more likely to rally, not decline, when rates are rising. Strong equity markets have tended to support corporate credit prices even when interest rates were rising.
- Historically, interest rates have not risen on a linear track — there have been numerous spikes and pullbacks, and we believe within that volatility lies opportunity for active bond managers.
- While passive fixed income investors may be in for a rocky ride toward less-attractive total returns, active bond managers have more flexibility to manage duration (for example, shifting allocation toward less rate-sensitive segments of the yield curve) and to use individual security selection in an effort to benefit from market dislocations.

Equities often rally, credit potentially benefits

Since 1970, there have been 21 periods in which the benchmark 10-year Treasury bond yield rose by at least 100 basis points (bp). In the 1990s and 2000s, equities — as reflected by the S&P 500 Index — rallied in all rising-rate periods (Exhibit 1). Equities rallied during roughly half of the rising-rate periods from the 1970s into the 1980s, partly because Fed policy was less effective in keeping inflation contained during those years. Equity returns historically have not shown much correlation to the magnitude of the yield change.

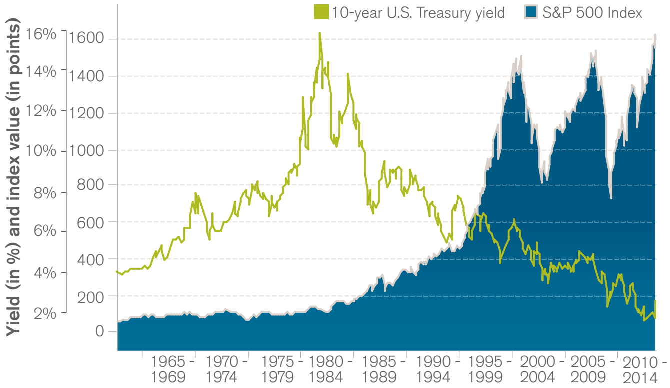
For fixed income investors, rising equity markets can buoy corporate credit even as interest rates are rising. Improving economic fundamentals also have tended to lead to lower credit default rates and enhanced company balance sheets.

Volatility creates opportunity

In general, declining interest rates have tended to support higher stock prices over the long term. But the progression has not been linear (Exhibit 2). Instead, both stock and bond prices progressed jaggedly along a trend line. If this pattern repeats itself, it should provide plenty of opportunity for active fixed income investors to buy on dips and sell on rallies.

Exhibit 2

S&P 500 vs. 10-year Treasury yield



Source: Bloomberg. As of 6/21/13.

We do not expect to see a violent, sustained move in interest rates, as this would be destabilizing to the economic recovery that the Fed has worked so strenuously to promote the past five years. Rather, we believe there will be a general upward trend in rates punctuated by periods of headline-driven volatility. This is part of a necessary process as investors start repricing assets for positive real rates of return (net of inflation), assessing the probability of an improving global economy and accepting that the artificially low interest rates of the past few years are not sustainable.

Like all significant change, these shifts can be painful as investors move through them. However, they have been common. We believe they can be navigated successfully by taking calculated risks, focusing on capital preservation and keeping a close eye out for the opportunities that come from interest rate changes.

Active management matters

As we've previously pointed out in various whitepapers (including *Why Credit Matters*, 2009, and *Redefining Risk in Fixed Income*, 2011) the major structural changes that have occurred in the U.S. fixed income market since 2008 have made the Barclays U.S. Aggregate Bond Index (Agg), a widely used proxy for passive fixed income investors, highly sensitive to interest rate changes. This means that nonactive investors using the Agg as a benchmark — whether in passive strategies or exchange-traded funds (ETFs) — are implicitly making a bullish bet on interest rates (i.e. that interest rates will decline). This was a beneficial strategy as rates were declining, but we doubt that most investors currently would be comfortable making a passive bet on a continued decline in rates.

While we believe that rates will trend higher, we don't view this as a terrible crisis for fixed income markets. On the contrary, we believe it is a natural repricing. Typically, periods of market repricing can create opportunities for active investors to buy securities at attractive valuations, reposition at different points along the yield curve and reallocate between asset classes, sectors and securities. All of this can be good for investors in terms of capital preservation and positioning for the next market cycle.

We believe one of the key elements of active versus passive management is the ability of an active manager to express a bearish view in the market by not owning the securities or segments of the market that have the most downside risk, or where investors are not being adequately compensated for risk (although when valuations fall, it is possible for both active and passively managed investments to lose value).

For instance, if one looks at interest rate sensitivity (duration) leading into the last seven notable rising interest rate years for 5-year, 10-year and 30-year Treasury securities (Exhibit 3), a pattern emerges. Since 1994, as interest rates have declined, sensitivity to rate changes (i.e. duration) has increased, particularly for the 30-year Treasury bond. We believe that the greatest risk of capital loss lies in the longer end of the yield curve, in securities maturing in 10 years or more, and we're closely monitoring that segment and taking steps to minimize our exposure.

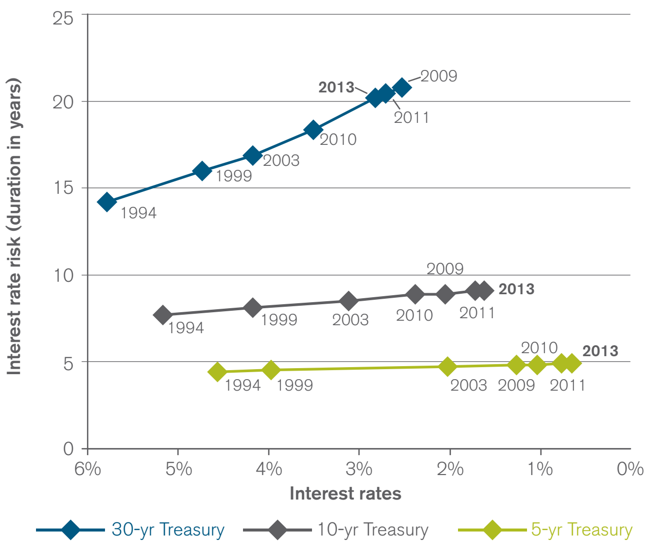
Navigating a post-QE world

Investors may fear entering a period of rising rates, but they don't need to be afraid. While navigating a rising-rate environment can be challenging, we believe that active fixed income management and expertise in security selection can be beneficial. After the shock of QE tapering subsides, we believe attention will focus even more closely on individual company fundamentals, and that the markets will reward companies that are making positive structural changes in their business and enhancing their balance sheets.

Change is unsettling, and a significant reversal in interest rates definitely would alter the fixed income landscape. However, change creates opportunity. In our view, bond managers that are experienced in risk management around duration and in employing fundamental, bottom-up security selection will be in a good position to help maximize risk-adjusted returns and preserve client capital.

Exhibit 3

Interest rate risk of Treasury securities during recent rising-rate periods



Source: Bloomberg. As of 6/21/13.