FIDUCIARIES DILEMMA

FIXED INCOME IN 2014

Jeff Detwiler, CFA, AAMS

Fixed Income Portfolio Manager

GH&A GARCIA HAMILTON & ASSOCIATES, L.P.

1401 McKinney, Suite 1600, Houston, TX, 77010 Office: 713-853-2322 | Fax: 713-853-2300
www.GarciaHamiltonAssociates.com

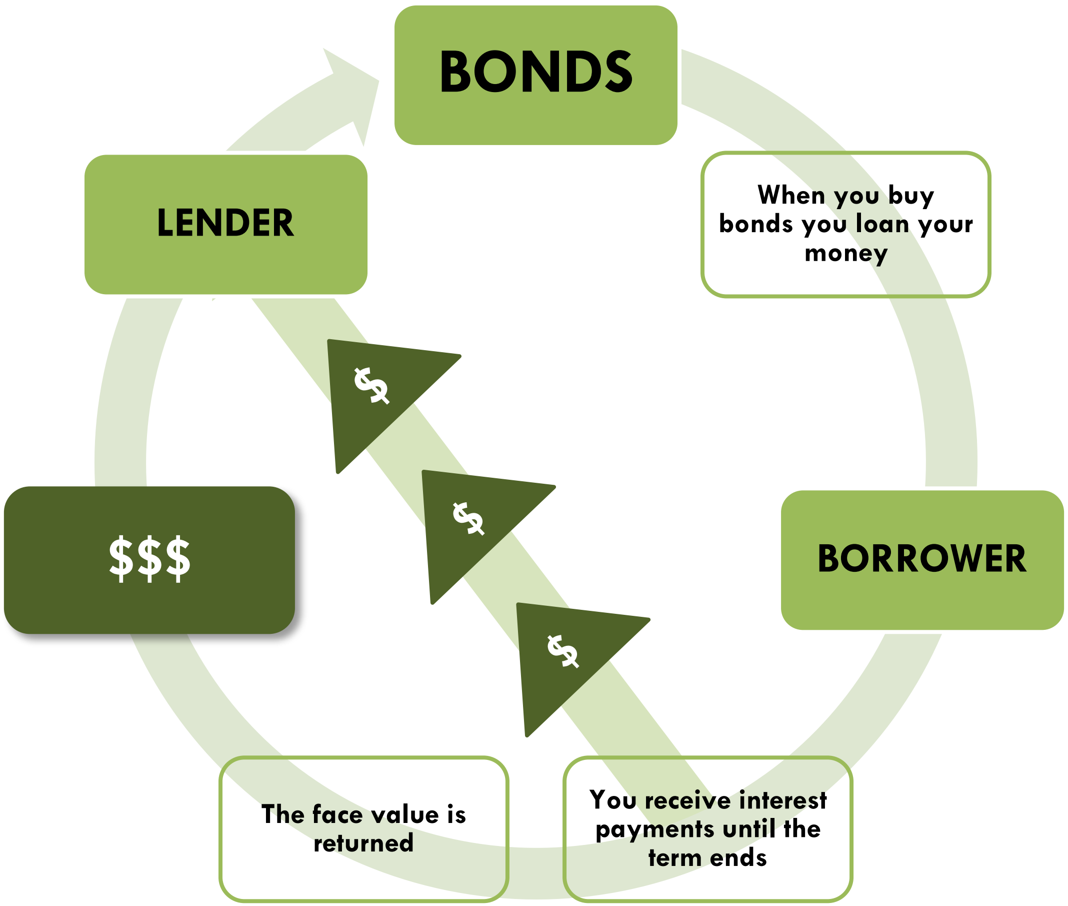
What are Bonds?

Bonds 101: What are bonds and why do they exist

- A bond is a debt security, similar to an **I.O.U.**
- When you purchase a bond, you are lending money to a an *issuer*.
- In return for that money, the issuer provides you with a promise to pay a specified rate of *interest* during the life of the bond and to repay the *principal* when it comes due.
- Even bigger than the stock market, the largest securities market in the world plays a vast and vital role on the global stage, in the U.S. economy, and the daily life of every American.

Sources: US Bond Market Outstanding: www.sifma.org/research/statistics.aspx, www.investinginbonds.com, www.treasurydirect.gov

Life of a Bond



Source: www.seekingalpha.com

Types of Bonds

Corporate

Mortgage-backed

Treasury

High Yield

Sources: www.theinvestorsnews.com, www.dailykos.com, istockphoto/RichardCano, www.forbes.com

Features: Coupon

Coupon:

A feature of a bond that denotes the amount of interest due, and the date payment will be made.

- A bond is normally an interest-only loan, meaning the borrower pays the interest every period, but none of the principal is repaid until the end of the loan.

Source: www.investinginbonds.com

Features: Maturity

Maturity:

The date when the principal amount of a security is due to be repaid.

- Generally, bond terms range from one year to 30 years
- **Short-term bonds** generally **offer lower yields**
- **Long-term bonds** generally **offer higher yields**

Source: www.investinginbonds.com

Features: Rating

Rating:

Designations used by credit rating agencies to give relative indications as to opinions of credit quality.

- Generally speaking, a **higher rating** means **less risk** but a **lower potential return** and vise-versa.

Source: www.investinginbonds.com

Risks

- All investments carry some degree of risk, which is linked to the return that investment will provide.

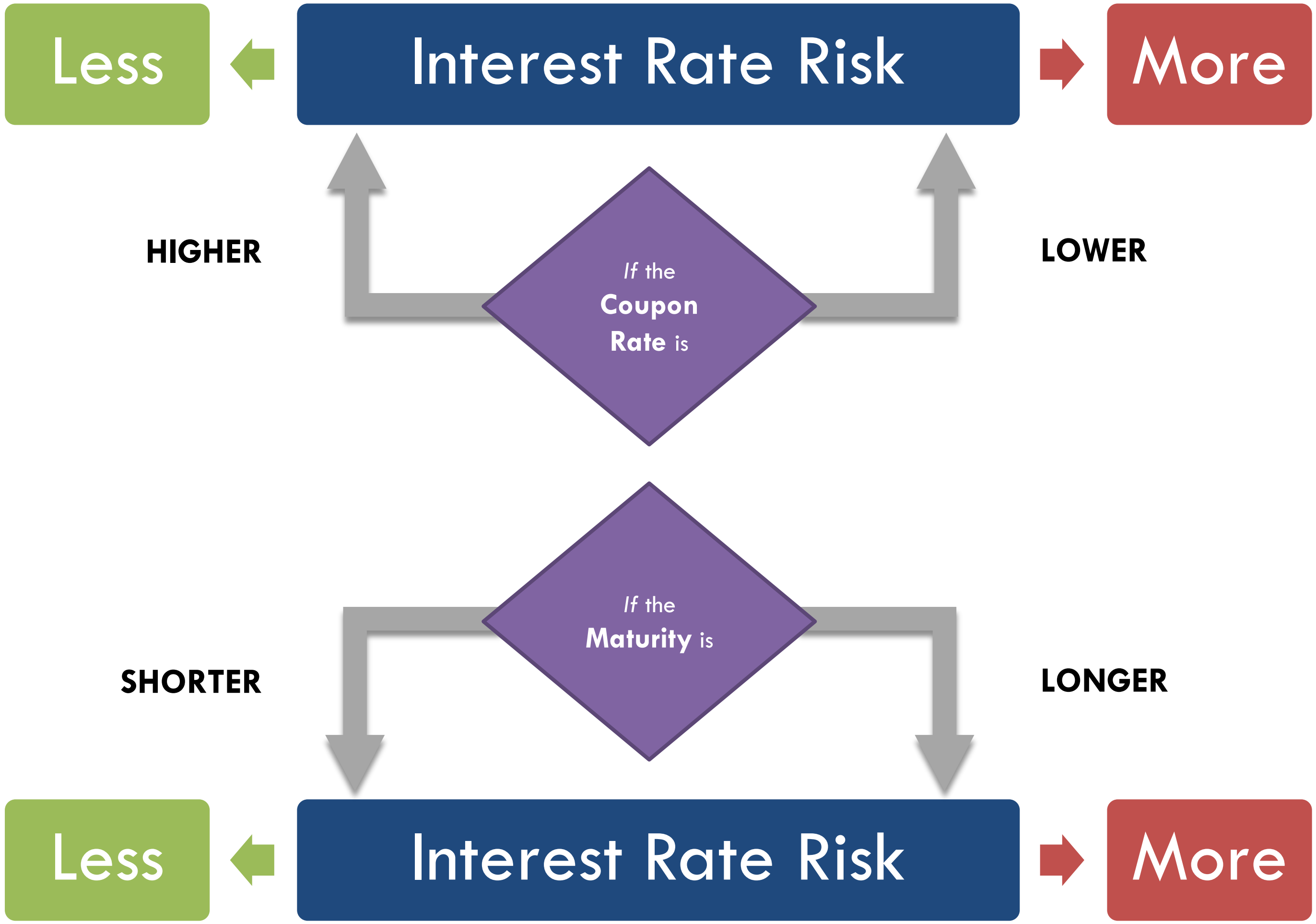
- A good rule of thumb is the higher the risk, the higher the return.

- Two types of Risk related to fixed income:
  - **Interest Rate Risk**
  - **Credit Risk**

Interest Rate Risk

- The risk that an **investment's value** will change due to a change in the **level of interest rates**.
- Interest rate risk affects the value of bonds more directly than stocks, and it is a **major risk** to all bondholders.
- As interest rates **rise**, bond prices **fall** and vice versa.
- How much interest rate risk a bond has depends on how **sensitive** its price is to interest rate changes in the market.
- The sensitivity depends on two things, the bond's time to **maturity** and the **coupon** rate of the bond.

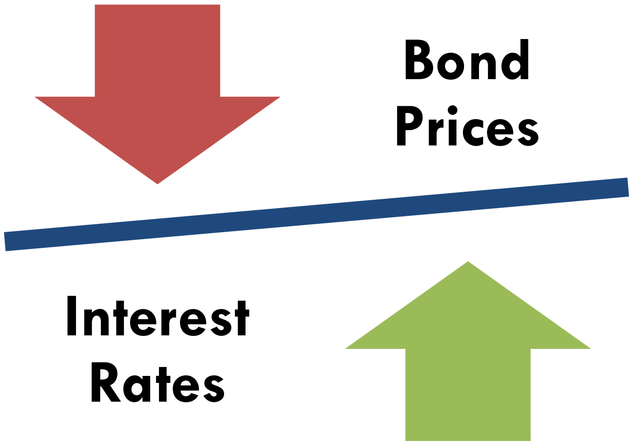
Interest Rate Risk



Source: www.web-books.com

Interest Rate Risk

- Interest rates and bond prices, then, are like a see-saw – when interest rates rise, bond prices fall (and vice versa).



- How much interest risk a bond has depends on how sensitive its price is to interest rate changes.
- **Duration** is a measure of the sensitivity of price change to interest rate changes.

Interest Rate Sensitivity

Duration Example

	Duration
Portfolio A	**5**
Portfolio B	**2**

Interest rates, in general, **RISE** by 100 BPS (1.0%).
Which portfolio **LOSES** value the most?

Portfolio A would **lose** approximately **5%**
Portfolio B would **lose** approximately **2%**

Interest rates, in general, **FALL** by 100 BPS (1.0%).
Which portfolio **GAINS** value the most?

Portfolio A would **gain** approximately **5%**
Portfolio B would **gain** approximately **2%**

Dates and data used are for illustration purposes only and may not reflect actual data as of the dates shown.

Credit Risk

- The risk that a borrower will default on any type of debt by failing to make payments which it is obligated to do.
  - This risk includes the loss of principal and interest payments or any disruption of cash flows.
  - The loss may be complete or partial and can arise in a number of circumstances.

- Credit risks are calculated based on the borrowers' overall ability to repay.

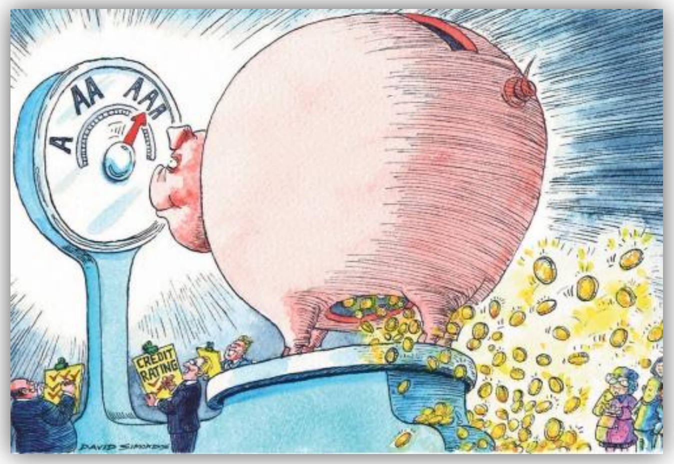
- The higher the perceived credit risk, the higher the rate of interest that investors will demand for lending their capital.

- Ratings agencies such as S&P, Moody's and Fitch evaluate the credit risks of thousands of corporate issuers and municipalities on an ongoing basis.

Credit Risk

Why quality matters…

- The debt ratings are an assessment of the creditworthiness of the issuer.
- An important thing to recognize about a bond's yield is that it is calculated assuming that all the promised payments will be made.
- As a result, it is really a promised yield, and it may or may not be what you will earn.
- If the issuer defaults, your actual yield will be much lower.



Source: www.theguardian.com

Credit Ratings*

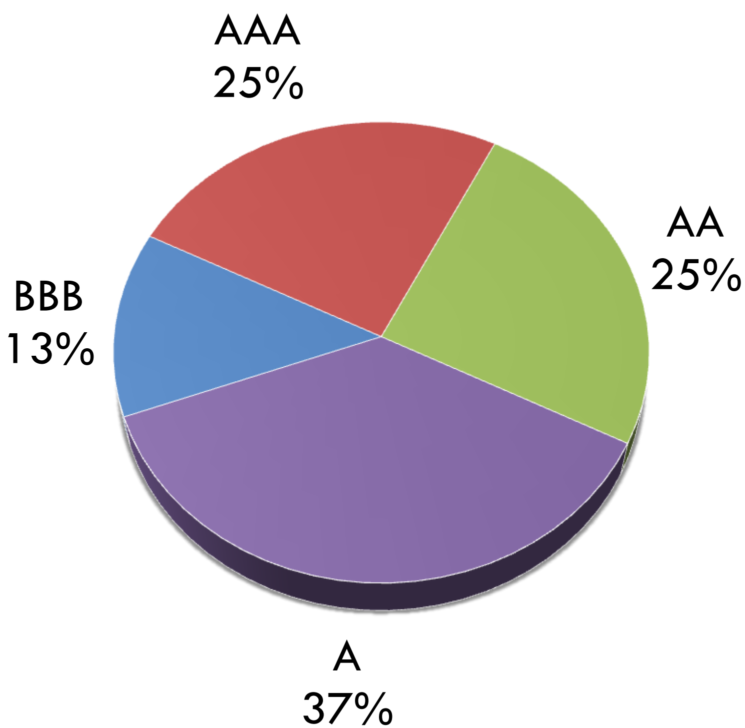
		MOODY's	STANDARD & POOR'S	FITCH
INVESTMENT GRADE	Strongest	Aaa	AAA	AAA
	↓	Aa	AA	AA
		A	A	A
		Baa	BBB	BBB
NON-INVESTMENT GRADE		Ba	BB	BB
		B	B	B
		Caa	CCC	CCC
	↑	Ca	CC	CC
		C	C	C
	Weakest	D	D	D

*These credit ratings are reflective of obligations with long-term maturities.

Source: www.investinginbonds.com

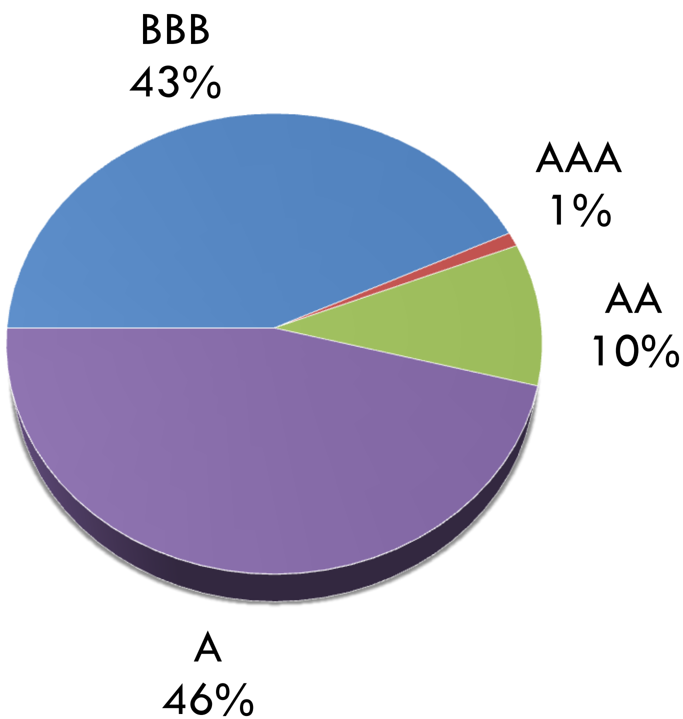
Corporate Credit Quality Distribution

1980



$178 Billion

Today



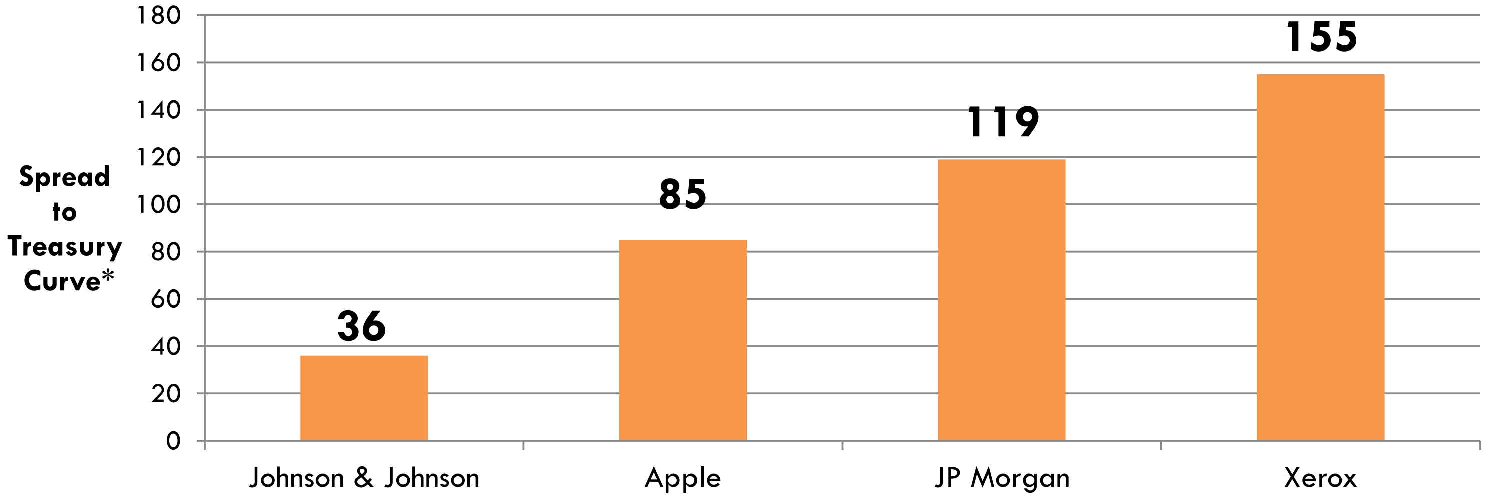
$4.0 Trillion

Source: Bloomberg, BarCap Live
Chart data is as of 12/31/1980 & 9/30/2014

Credit Risk

Ratings	Examples	% of Index*
AAA	Johnson & Johnson, Microsoft, Exxon Mobil	1.0%
AA	Apple, Wal-Mart, IBM, Chevron	9.6%
A	JP Morgan, Wells Fargo, AT&T, Pepsi, Target	46.2%
BBB	Xerox, Capital One, Raymond James, Waste Management	43.3%

*Percentage of Barclays Capital Investment Grade Corporate Index



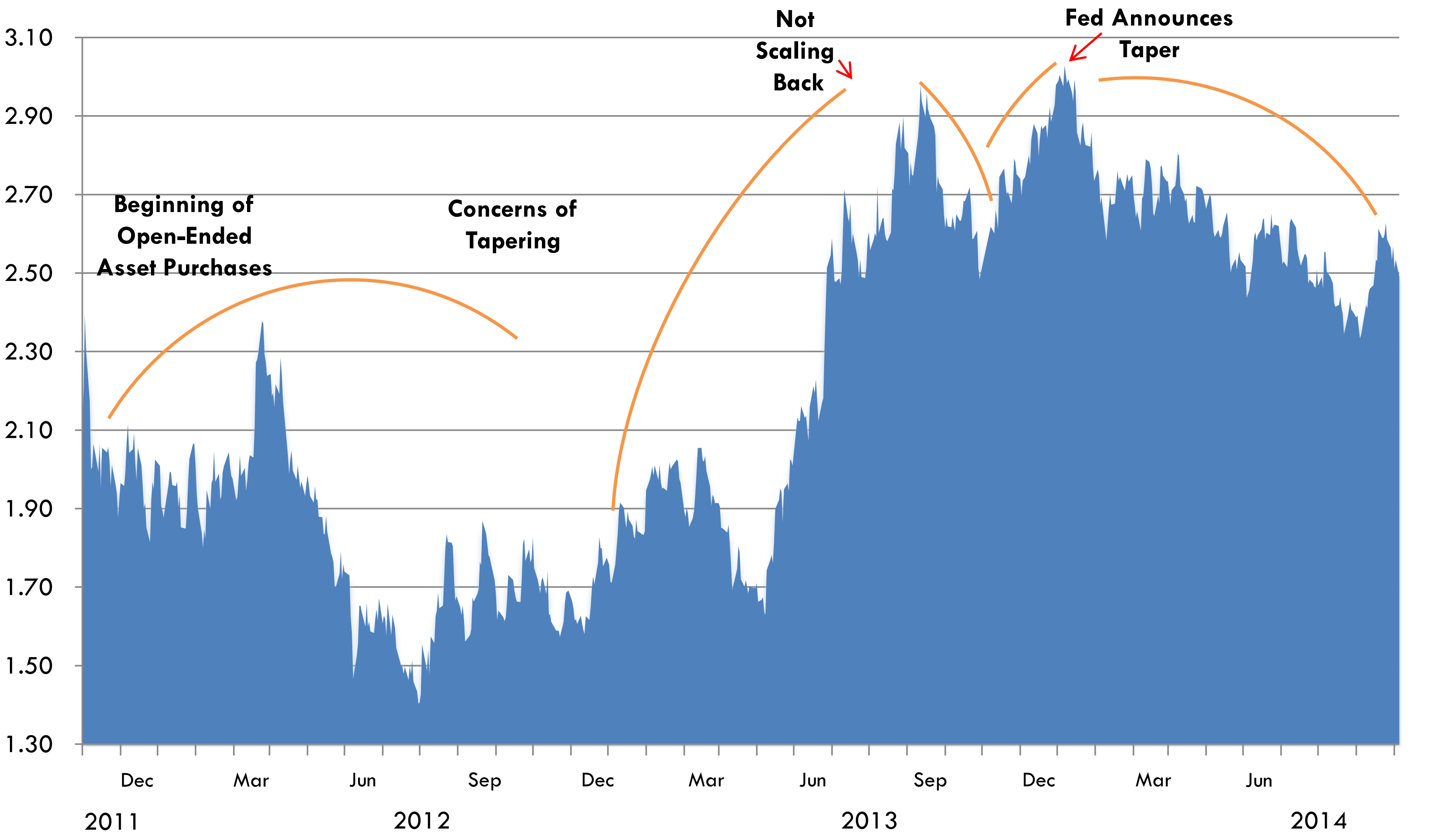
*Ten Year Corporate Bond Yield minus Interpolated Government Yield.

Source: Bloomberg, BarCap Live
As of 9/30/2014

Dilemmas and Risks Today

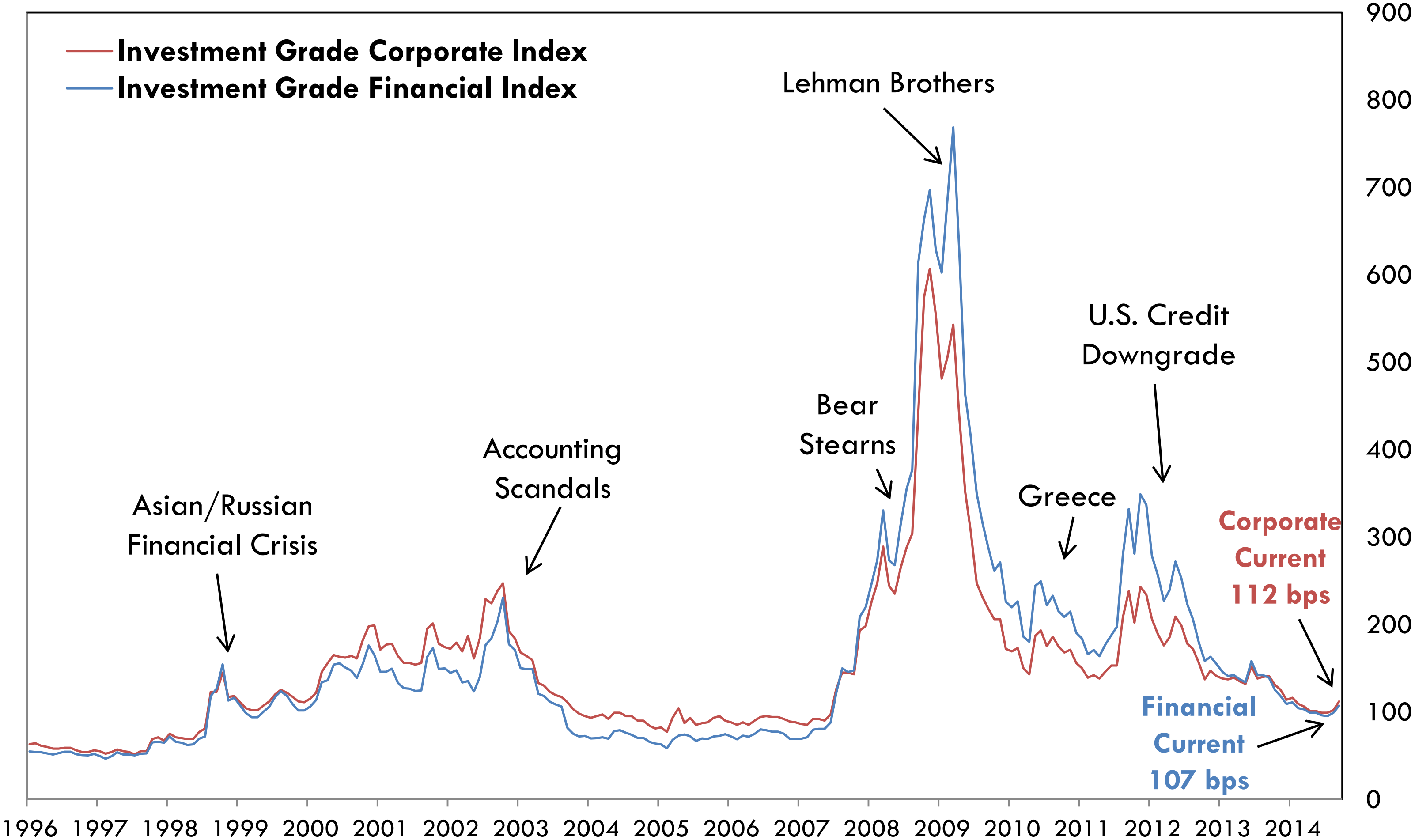
- Low Yield Environment
- Potential Rise in Rates
- Limited Opportunity in Spread Product

Graph of 10-Year Treasury Yield



Source: Bloomberg
Last Update: 9/30/2014

Average Option Adjusted Spreads (OAS)



Source: Barclays Live
Last Update: 9/30/2014

Conclusion

- Recognize the interest rate risk and credit risk in your fixed income portfolios

- Understand the risk/return trade-off

- Evaluate your asset allocation