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The Rise

For most of the last two years, fixed income investors have strived to understand a future with higher interest rates. Or more accurately, to understand the journey to higher rates. For many, the seemingly endless quest to stress test their portfolio holdings under various rising rate assumptions, so called "scenario analysis," has stirred debate about their own future as investors dedicated to the notion of holding securities with fixed rates of return as part of their overall portfolio. While prudent and useful, the wide variety of variables, assumptions and inputs necessary for these exercises along with the shortcomings of many scenario models has resulted in largely inconclusive findings. Far more difficult to achieve is gaining a clear consensus of how fiduciaries will react to negative returns on one of the most conservative portions of their portfolios. With many "risk on" investments reaching new highs on a weekly basis, it is particularly important and timely for investors to revisit their expectations for the performance of their fixed income allocations in the face of rising rates. This is especially true now as the potential for prudent reallocations to these commitments will be a topic for many investment boards and their advisors as they meet to review annual performance of their investment portfolios.

"Aint Nothing Like the Real Thing"

R&B Artists Marvin Gaye and Tammi Terrell got to the essence of the shortcomings of scenario analysis with the title of their 1968 hit, "Ain't Nothing Like the Real Thing." Starting in early May and continuing until early September of 2013, fixed income investors were provided the ultimate "real thing" stress test for their portfolios. The mere speculation of a less accommodating Fed associated with a steadily improving economy delivered a valuable scenario from which to consider the realities of rising rates. Indeed, not only did investors get a real time experience of the impact of rising rates, but the Fed and central banks around the world conducted a warm up exercise for managing the reactions of various stakeholders…both financial and political. Like a new soldier who one day realizes that the drill sergeant is firing live ammo in what was previously only a simulated training exercise, investors now had the "real thing" to deal with as their investment strategies reacted to the reality that near zero rates do not last forever.

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So What Did We Learn?

As managers of fixed income portfolios for institutional investors, the learning opportunities from this period were significant. Here is a short list of some of these valuable lessons:

1. This all happens quickly: Starting in early May and continuing until early September, the ten year yield rose an astonishing 84%. For context, it took over 12 years for a drop approaching that magnitude (80% drop in the ten year yield between 2000 and 2012). And during that period investors were generally making money from a combination of collecting coupon and price appreciation due to falling rates.

2. Bond basics are not always so basic: Thirty years of generally falling rates have conditioned many long only fixed income investors to expect generally pleasant (or no) surprises in quarterly reports. Like residents of a barrier beach island that is suddenly rearranged by a fierce winter storm after many years of only minor erosion, investors were confronted with the notion that short term losses in even an all Treasury portfolio are a distinct possibility. Despite a clear understanding of bond basics (as rates go up, prices go down), many investment boards and staff were caught off guard with their own reactions to negative returns in these conservative portfolios.

Figure 1 displays the impact of spread widening during the rise of rates in May and June of 2013.

3. Spread Impact: The negative price performance over this period was exacerbated by spread widening. The pain of rising rates is real enough, but when spread widening occurs at the same time the pain is particularly acute. The table below shows the total returns in basis points (bps) for two Barclays US Treasury indices and two Barclays Credit indices of comparable duration.

Figure 1: Barclays Indices Comparison (April 30-June 28, 2013)

Index	Performance Return
1-3 Year Treasury	-21 bps
1-3 Year Credit	-45 bps
7-10 Year Treasury	-553 bps
7-10 Year Credit	-651 bps

*Source: Barclays Live

Two things are clear:

- The longer the duration the worse the performance
- Given a particular duration, the addition of credit securities worsened the performance.

4. Cash Flows Rule: Not all fixed income securities are created equal with regards to the timing of repayments. For example, Residential Mortgage Backed Securities (RMBS), Commercial Mortgage Backed Securities (CMBS) and many Asset Backed Securities (ABS) are amortizing bonds that have a schedule of periodic payments of both principal and interest. Traditionally, theses accelerated cash flows have been attractive to investors who look for improving credit quality as the principal pays down, typically monthly. However, in periods of rising interest rates, these steady payments of both principal and interest provide an additional and valuable benefit as the cash flows are invested at higher rates. The spring and summer environment of 2013 reminded many investors that accelerated cash flows provide both a financial and psychological benefit, particularly as rates rise. Monthly cash flows also benefit investors during times of spread volatility and bouts of illiquidity. When

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markets enter "risk off" modes it is often difficult to take advantage of compelling opportunities since investors need to sell one security to buy another. A portfolio generating meaningful monthly cash flows has a natural source of capital to reinvest into the market without bearing the cost of the bid-ask spread.

Everybody Wants to Go To Heaven, But Nobody Wants to...

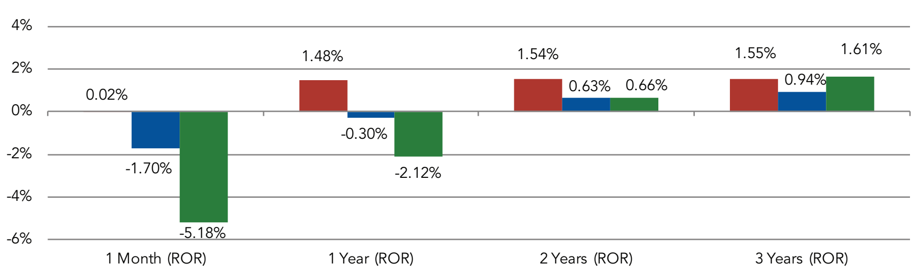
Everyone wants to invest at higher rates but few investors want to experience the pain and associated recovery lag from the journey upward. Fortunately, fixed income investors at the short end of the curve don't have to "die" to benefit from higher rates. In fact, as cash flows spin off the portfolio (and are reinvested at higher rates) and the remaining bonds pull back to par over time, investors very quickly benefit from an increase in rates. This does not hold as true for investors out the yield curve. It takes a much longer time for a ten year bond to pull back to par (incidentally about ten years) than a two year bond.

Figure 2 highlights the recovery times of three key indices during a simulated rising rate environment.

One way to look at portfolios across the curve and how they react to a rise in rates is through analysis that shows how soon an investor is better off if rates go up by 100 bps. This is based on a combination of the portfolio duration and the yield. Figure 2 shows the results for three different portfolios indices. In this scenario, the recovery time (that is the time it takes to recover the losses and get back to zero total return, a.k.a. "Breakeven") is about twenty months for the Barclays Aggregate Index, while it is less than a month for the Barclays Floating Rate Note Index. Ultimately, all fixed income investors in this analysis not only get back to even but are actually better off due to rising rates. Using those same three indices we can see how long (in months) it takes to completely recover losses and actually fully benefit from the steep rise in rates. For some long term investors, five and a half years (67 months) may be palatable as they stay the course of their overall investment strategy. However, many investors we talked to during last spring and summer got a renewed understanding of which allocations were well suited to withstand the storm and which required a different approach. For example, allocations of funds earmarked for a particular short term purpose (such as the construction of a new facility in 2 years' time) may not be a good candidate for an Intermediate duration strategy (or even Short Term duration). Instead, this allocation may be an excellent candidate for a conservative floating

Figure 2: Total Return (100 bps Parallel Shift) and Characteristics

	Yield	Duration (yrs)
BC US FRN	0.58%	0.11
BC 1-3 Yr G/C	0.55%	1.83
BC Aggregate	2.47%	5.47



	Breakeven (months)	Exceed Base (months)
BC US FRN	1	2
BC 1-3 Yr G/C	15	23
BC Aggregate	20	67

Source: Barclays Live, Merganser. Note: All periods longer than twelve months have been annualized. Data as of December 31, 2013.

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rate bond strategy that offers yields well above today's money market rates and is constructed to benefit directly from rising rates.

Fortunately there are many alternatives

In January of 2014, the US Treasury will issue their first new product since 1997.

It takes an astute memory to recall a time when yields rose over a sustained period of time and thus it is not surprising that the price performance of fixed income in May and June 2013 was jarring to some. The natural reaction is to shorten portfolio duration, which is very prudent if you wish to protect capital during a period of rising rates. Unfortunately, most high quality portfolios that have a duration of 1 year or less have yields in the low to mid double digits (in basis points) – in large part because the maturity of the underlying holdings is limited. A floating rate portfolio provides the benefits of a short duration portfolio while retaining the flexibility to hold longer maturity securities – and the yield that comes with them. The strategy to mimic the quality and liquidity of a traditional actively managed core account with close to zero interest duration is possible. The Merganser Floating Rate Bond Strategy is focused on investment grade bonds across fixed income sectors to maintain diversification. This strategy by itself, or combined with a higher risk floating rate strategy such as bank loans, may provide some investors a compelling alternative to staying in longer duration core accounts.

Floating rate securities recently got a meaningful endorsement from the United States Treasury with their announcement at the end of last year that they will issue floating-rate notes at the end of January 2014. With the world's largest issuer of debt adding floating rate securities (their first new product introduction since 1997) we believe the demand for these strategies will increase dramatically leading to a larger and more mature market with a growing number of alternatives for institutional investors looking for ways to navigate a rising rate environment.

For more information on the Merganser Floating Rate Bond Strategy, please visit www.merganser.com.

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