

TIMELY TOPICS

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Bringing Risk Management to Your Bond Portfolios A YieldQuest Commentary

While the concept of risk management is typically not one embraced by bond investors, especially those who own a large proportion of government and agency securities, we at YieldQuest believe it is imperative for our clients to incorporate risk management into their fixed income portfolio strategies at this time, given what many market commentators have referred to as a potential bubble in Treasury bonds (we agree with this bubble assessment). The generational lows in Treasury yields, we believe, strongly support our recommendation for investors to focus on the inherent risk embedded in their portfolios on a look-forward basis from holding an un-hedged allocation to Treasuries and other fixed income securities, especially un-hedged bond funds.

With the 5-year Treasury now yielding 2.28%, some clients continue to argue that there may remain some potential reward in holding current Treasury allocations. Possibly. But as investment professionals paid to balance risk and reward for our clients, and with Treasury yields still relatively close to 50-year lows, it would be imprudent, in our view, to leave your bond portfolios un-hedged at this time, given the significant risk that rates are likely to reverse course and rise at some point over the coming months on the back of stronger than expected economic growth both in the U.S. and abroad and the potential for an upside inflation surprise.

For this reason, we strongly recommend that clients incorporate risk management via an interest rate hedge into their bond portfolios. Essentially, this would require that you give up some of the additional upside if Treasury yields were to decline further from here, in return for potentially protecting your portfolios and mitigating losses as rates rise over time. Given the potential for very large increases in rates over the coming 6-24 months, this hedged portfolio may be bought and held for the intermediate term.

How would YieldQuest seek to achieve this risk/reward balance within client portfolios?

- Dramatically reduce or possibly eliminate unhedged bond funds from portfolios, given their typically significant allocation to Treasuries and positive duration in general.
- Maximize yield and principal preservation by favoring individual bonds over bond funds. Remember a high quality individual bond held to maturity delivers your principal upon maturity.
- Incorporate other YieldQuest strategies to help position portfolios for rising rates. Contact your YieldQuest representative for details.

Admittedly, the above recommendations would involve somewhat higher turnover within client portfolios, but we believe this is a small price to pay in return for potentially enhanced protection against rising rates.

We look forward to discussing these ideas and our specific hedging recommendations with you on a one-on-one basis.

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