RBC Wealth Management

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"Prediction is hard. Especially about the future."

— Yogi Berra, circa 1966

Dear Friends,

This is the third or fourth time in the past ten years that we have relied upon Yogi to set the stage for our sharing yet another brilliant concept with you. We are not certain what that means about our level of sophistication given that Yogi quit school after completing the eighth grade. But great prose is just that…great. Even if you need to think about it twice. (Probably what Yogi had in mind.)

Interesting

The stock market this year has drawn most of investors' attention starting the year up by nearly 6% in the first two months before…COVID. In the <u>month</u> of March, stocks fell by over 34%. But stocks were not the only thing that fell sharply early in the year. So did interest rates. The ten-year US Treasury bond opened the year yielding 1.88% and by early August it hit a low of .52%, as in a drop in yield of 72%. Rather quietly the same T-bond has moved up in yield in recent weeks to .88%. Hardly a high rate but certainly an increase from .52%.

Investors watch the prices of the stocks they own with a high degree of self interest. Bonds? Not so much. Primarily we care about safety and interest income. We thought it might be interesting to discuss the risks that arise when interest rates eventually begin to increase: in particular as it applies to longer term bonds defined as ten years to maturity and longer. As freely traded securities, US Treasuries do change in price daily but in a way that is inversely correlated to changes in interest rates. When interest rates go down, as they have done over the past thirty years, bond prices go up. Why? Would you prefer to get a higher rate of interest or a lower one? Obviously higher. The way the market works is for that ten-year Treasury to increase in its *market* value as rates decline. The reverse is true when rates go up. A bond issued when rates were lower than the current rate being paid today will trade at a discount to its value at maturity to make up for the inferior rate of interest being paid between now and year ten.

Let's put numbers on the concept. Assume that in <u>one year</u> rates on ten-year Treasuries have risen from a low of .52% to 2%, still a low rate historically. At what price would our Treasury bond investment be trading? Yogi, may we have the envelope please? 88.82 or $888.20 for each $1,000 invested. Quite literally, in the event we needed access to that cash invested in our 2030 Treasury bond for whatever the reason and had to sell at this price, our return for the year would be approximately *minus* 11%. Hardly our idea of a safe harbor.

In stark contrast, our practice has been and continues to be purchasing short term CDs and corporate bonds generally maturing in a matter of months and, on occasion, out to eighteen months. The benefit is that when we do need to raise cash near universally it has not resulted in a loss of principal to our clients. But in so saying, it is also important to point out that we receive modestly lower interest rate returns than if we had purchased those maturing in ten years.

Last point: for nearly all of you, a majority of the money we manage on your behalf is invested in common stocks. Not only has the return from *dividends* been above the 1-2% that Treasury bonds have been paying in recent years, but as measured by the broad market averages, you have also enjoyed growth in your principal. Over time we fully expect the Federal Reserve will eventually take its foot off the interest rate brakes and bonds will again become more competitive with stocks. But for the time being, attempting to solve for higher rates of income by investing well out into the future is a witch's brew of not much improvement in income coupled with significantly increased risk.

Like you, down here at the stock and bond factory we always look forward to the Thanksgiving holiday as a chance for a few days off to be with family, over-eat and to express our appreciation for the many blessings we enjoy. Clearly this year will be different but for one thing: our team's greatest blessing is all of you. Our thanks go out for your support of our endeavors and more importantly for your friendship. Keep out of harm's way. You are irreplaceable to your loved ones and to your friends, including us!

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