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February 2014

Old Yellen...a Rabid Follower?

With newly minted Federal Reserve Chair Janet Yellen taking over her post in the midst of extraordinary global monetary stimulation, it makes sense to discuss interest rates and fixed income investing – two things she is now fully in charge of managing. Ms. Yellen is clearly a bright academic, but she is taking the helm at a challenging time when an unprecedented amount of Fed stimulus is just starting to be eased.

Our bet is that this hardworking, Brooklyn native who collects stamps and studies Economics with her Nobel laureate husband will offer markets a refreshing, but not earth-shattering change over her predecessors.

Big Ben's Time is Up

At its most recent meeting (Ben Bernanke's last), the Fed decided to reduce its unorthodox monthly purchases of bonds to *only* $65 billion per month, $10 billion less than the prior month. This slows the growth of the Fed's balance sheet, which now holds $4.1 trillion in bonds. Current conjecture assumes that similar $10 billion stair-step reductions will take place until the program is stopped sometime this Fall. As a point of emphasis, the Fed's official release left unchanged its language that it will hold its target short-term interest rate near zero "well past the time" that unemployment falls below 6.5%, which is near its current level.

Let's be reminded that the Fed operates under a "dual mandate" from Congress—monitoring prices (i.e. inflation) and encouraging full employment. These limited objectives give us pause since being so narrowly focused may cause unintended consequences. Imagine driving a car with the "dual mandate" of controlling vehicle speed and engine temperature—with no real concern for tire pressure, RPMs or fuel level. What is currently unknown is whether the Fed, by seeking satisfaction on their confining targets, is imprudently distorting stock prices, auto purchases, housing and emerging markets—all metrics that are being messily sorted out thus far in 2014.

Market Timing with Bonds is Problematic Too

In this environment, many have embraced the narrative that generally goes as follows: rates must rise, bond prices must fall and it is "risky" to own bonds with anything other than a short maturity date. We believe this oversimplifies bond investing and ignores a primary reason for owning bonds—to preserve capital and earn a reasonably certain rate of return.

In this era of massive central bank intervention at the Fed and around the world, we believe that anyone who claims to know for sure where interest rates are going and when they will get there is either naïve or dishonest. Interest rates are difficult to forecast in the best of times—to say nothing of after the country has thwarted depression with trillions of bond buying and deficit spending. We worry that too many investors—justifiably fearing a big jump in interest rates due to unusual Fed policies—are sitting in cash waiting for higher interest rates. The problem with timing the market is that despite reasoned prognostications, there is every chance that rates remain low longer than expected, leaving an investor with essentially no return.

Please forgive the academic exercise (in honor of Janet Yellen), and allow us to demonstrate that the expectation of rising rates is already built into the "yield curve" which specifies interest rates investors can earn over various lengths of time. The yield curve explains why a borrower (e.g. a government or corporation) might pay you 0.50% interest for lending them money for the next 2 years, but may offer you 3.5% interest if

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you lend to them for 10 years. Accordingly, if an investor wants to maximize return over that time period, the critical question to answer is not whether rates will rise, but if they will rise faster (or more slowly) than markets expect.

For example, when an investor buys a $100,000 bond maturing in 10 years with a 3.5% interest rate, they have bought a contractual instrument that promises them full return of principal with specified interest payments along the way. Barring a default by the borrower, that means the investor will end up with $141,060 ten years from now[1]. When it is reported that "rates rose and bonds lost value" that statement is reflecting a "paper loss" and has no negative impact on the contractual payments the investor will receive on the bond they own.

Still, if higher rates could help you earn a higher return in the future, why not wait for rates to rise and then invest your money? The reality of the "steep" yield curve means that you "pay to wait" by earning only 0.10% on your money until rates rise. Sure, after three years of little return, you may be able to buy a 7-year bond at a 5.0% interest rate, but in this scenario you end up with essentially no more money 10 years from now than had you bought a 10-year bond at 3.5% to begin with. In the meantime, there may be another recession that entices Yellen to hold rates down longer than expected, and you could end up with far less return on your money over that 10-year period.

Then how does Hamilton Point invest bond portfolios when there is so much uncertainty about interest rates? Our solution involves constructing a portfolio of bonds with "laddered maturities." For example, if we earmark $1 million for long-term bond investment we might buy five $200,000 bonds maturing in years 2, 4, 6, 8, and 10, respectively. We are not fighting the reality of the yield curve as previously described, but our strategy of building laddered maturities of bonds balances the goal of having bond investments produce cash returns while preserving capital and flexibility to reinvest maturing bonds if rates change in an unexpected fashion over time.

Young Yellen

Returning to the Fed, their change in leadership now violates the adage "don't change horses in midstream (of liquidity?)." While we believe Ms. Yellen thinks enough like her predecessor to make the change in riders relatively smooth—the stream remains challenging to cross. Yellen is incredibly smart and completely familiar having most recently been Vice Chair of the Fed. Unlike Larry Summers who was considered for her job, Yellen seems neither brash nor overtly political and does not draw gigantic consulting fees from the financial organizations she is regulating. Perhaps most importantly she was not part of the Wall Street/Washington clique that rescued the big banks in 2008—fellas who, mind you, solved our "too big to fail problem" by making surviving banks bigger.

Ms. Yellen is an insider in terms of experience and academic chumminess, but a bit of an outsider with respect to her independence. Our best guess is that she would tolerate more inflation than most if it meant more jobs for Americans, a formula for a "dovish" stance and continued easing (i.e. lower rates) in current circumstances. Either way, in an environment where she is looking to encourage growth and inflation, and given her passion for stamp collection, a savvy academic like Ms. Yellen just might be loading up on "Forever Stamps." Class dismissed!

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1) Assumes annual, compounded interest payments for simplicity of illustration.