MARKET COMMENTARY

THE CASE FOR LADDERING BONDS

After an extended period of historically low interest rates, income-focused bond investors have finally found relief as interest rates have risen to levels not seen since late 2007 (see Chart A on page 4). Time to declare victory, right? If only it were that simple. There are external forces that influence the bond market, none more so than the Federal Reserve (Fed).

Who knows what the Fed will do and when? Could they start cutting interest rates this year after two years spent increasing them? Chart B on page 4 shows the twenty-year history of the Fed Funds Target Rate. Nobody knows for sure what will happen to interest rates in the future. There are potential ranges of plausible outcomes, but in reality, the future direction of interest rates is unknowable. What is knowable is today's level of interest rates. So, an investor interested in knowing the nominal dollar return of a T-bill or zero-coupon U.S. Treasury can know that future return with certainty today. This is not true for stocks and other fixed-income assets.

Is there a way for bond investors to "win" if interest rates fall? What if they continue to move higher? We think laddering bonds in one way to navigate an uncertain and changing environment.

BUILDING A LADDER

One way of mitigating risk no matter the interest rate environment would be to invest in individual bonds with staggered maturities. The proceeds from maturing bonds are systematically reinvested at the prevailing rate of interest as time passes and bonds mature. This simple strategy is called a bond ladder. The average income would be lower than owning all long-term bonds, but the risk would be reduced and flexibility increased.

In a 10-year ladder, bonds are staggered across maturities one to ten years. A simple ten-year ladder would have 10% of the portfolio value invested in one-year bonds, 10% invested in two-year bonds, and so on out to year ten. At the beginning of the second year, when the initial one-year bonds mature, the cash proceeds are reinvested into a new ten-year bond. This process can continue indefinitely and the average portfolio yield will adjust as new bonds are introduced into the portfolio gradually over time.

This is a simple and straightforward strategy that is designed to:

- Generate a consistent stream of income;
- Lower risk compared to fixed investment in long-dated bonds;
- Help manage risk; and
- Adjust to a changing interest rate environment over time

STABLE PRINCIPAL AND INCOME

While the market value of the ladder will fluctuate with the interest rate environment, the principal value of the portfolio will not be affected (provided bonds are held to maturity and the issuer does not default). The principal value, along with the income stream received, is not changed by fluctuating interest rates. If held to maturity, paper gains and losses are never realized, and the income stream remains predictable.

KNOW YOUR RISK AND RETIRE FROM THE FORECASTING GAME

Some bond strategies require making frequent changes to holdings in pursuit of return. In contrast, a laddering strategy makes no attempt to time the bond market. Instead, the portfolio always maintains a relatively fixed average maturity. In the case of a ten-year ladder, the average maturity is approximately 5.5 years. Since average maturity is linked closely to interest rate risk, having a stable average maturity makes it easier to know

how much risk is in the portfolio at any point in time. In exchange for this greater risk clarity, the potential for higher returns from successfully timing turns in the interest rate cycle are foregone. While there have been some successful managers in the past, those investors who can consistently time interest rate changes are the exception rather than the rule. Instead of basing an investment program on attempting to time the interest rate cycle, laddering offers a simple way of investing in bonds across a variety of interest rate cycles.

OPTIONS FOR HIGHER YIELD

Of course a ladder need not be constructed out of Treasury bonds. Corporate bonds, municipal bonds, and foreign bonds each offer differing levels of after-tax return above Treasuries. They also carry different levels of default risk. While corporate bonds have higher risk of default than the U.S. government, investment grade bonds almost always offer higher yields than U.S. Treasuries. Since the beginning of 1997 through January of this year, long-term AA rated investment grade bonds have generally yielded about 1.0% more than U.S. Treasuries. (Source: Ice Data Indices, LLC).

CONCLUSION

We believe that bond investors should educate themselves about options to invest in an uncertain environment. We think bond laddering is a sensible and practical way to invest the fixed income part of a balanced portfolio given uncertainties that lie ahead.

IMPORTANT DISCLOSURES

Bond laddering does not assure a profit or protect against loss. Yields and market values will fluctuate, and if sold prior to maturity, bonds may be worth more or less than the original investment. Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors.

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Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark. This commentary often expresses opinions about the direction of market, investment sector and other trends. The opinions should not be considered predictions of future results. The information contained in this report is based on sources believed to be reliable, but is not guaranteed and not necessarily complete.

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CHART A | 10 YEAR U.S. TREASURY BOND YIELD Source: Bloomberg

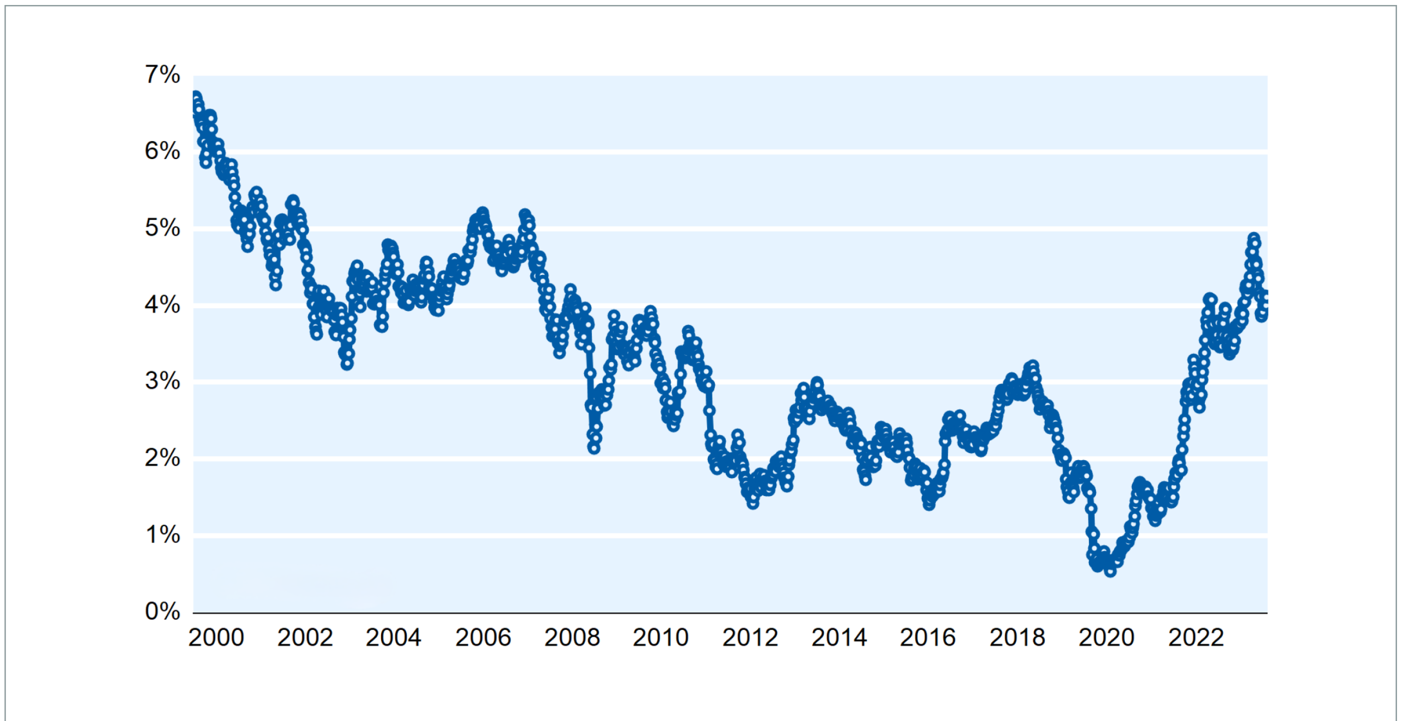
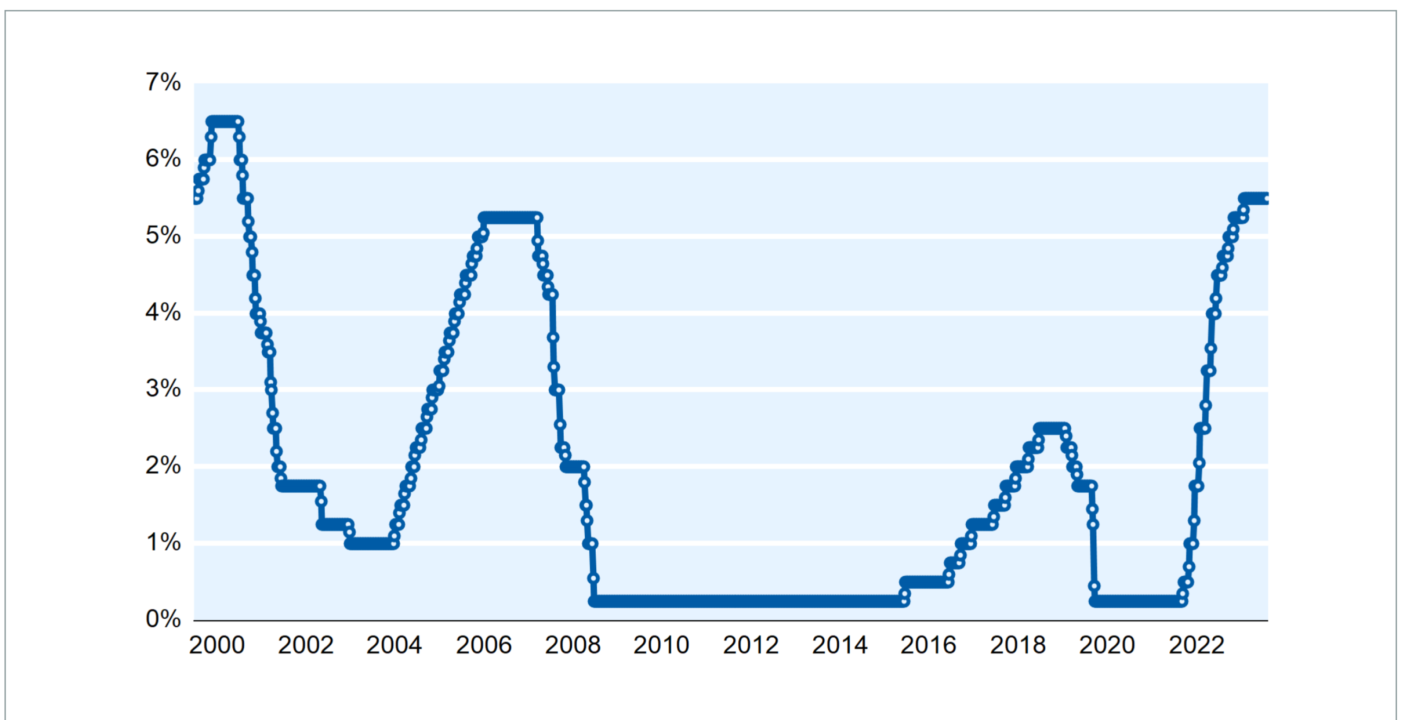


CHART B | SHORT-TERM POLICY RATE (FEDERAL FUNDS RATE) Source: Bloomberg



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Index Descriptions: WCA Quality Indices are based on Washington Crossing Advisors' quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.
S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Equity investments are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors to varying degrees. Fixed Income investments are subject to market, market liquidity, issuer, investment style, interest rate, credit quality, and call risks, among other factors to varying degrees. Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark. A forward contract is a type of customizable derivative contract that involves two parties who agree to buy or sell a specific asset at a set price by a certain date in the future. Forwards are similar to futures contracts, but they are made over the counter (OTC) and settle only once, on their expiration date.

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