SFS Investment Update

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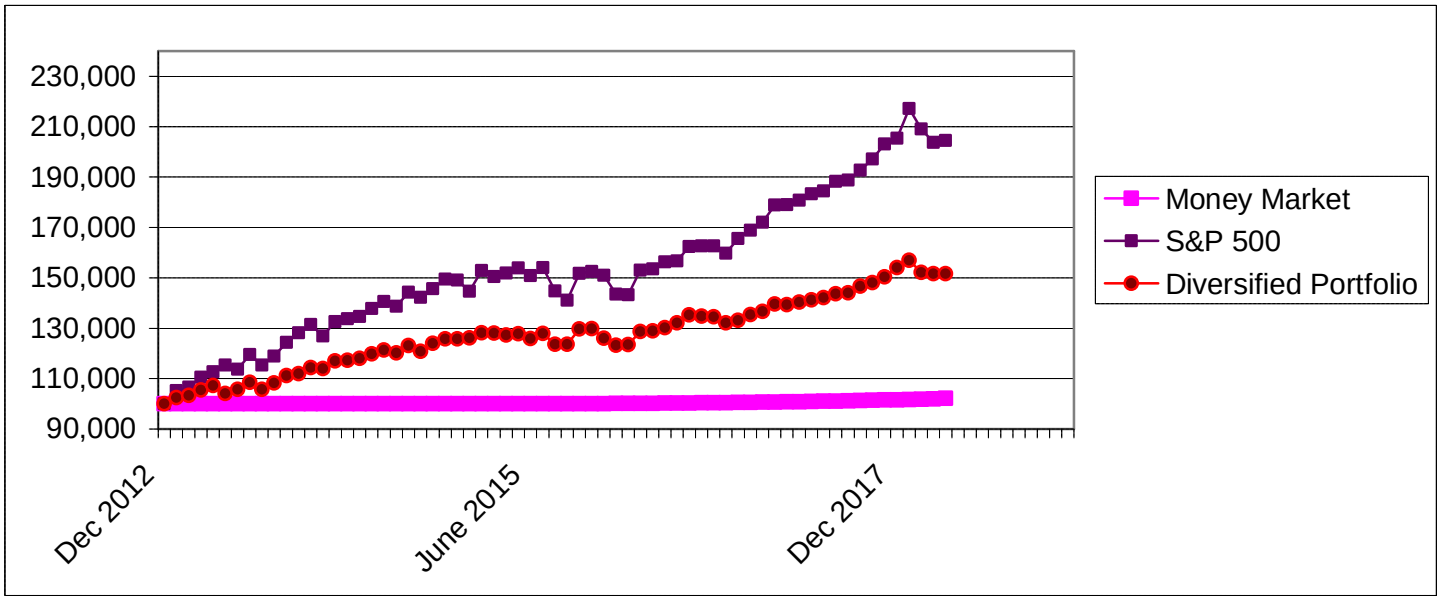
Bonds and Interest Rates

After a very crazy and volatile first quarter, the markets managed to finally calm down and generally move upward. The principal issue remains interest rates, their direct impact on bonds and the secondary impact on other investments.



	April	Year-to-Date	Annualized Since 1/1/2013
Diversified Portfolio	**0.02**	**(1.59)**	**8.12**
Index Components			
U.S. Stocks	0.38	(0.24)	15.29
International Stocks	0.83	0.35	7.00
Bonds	(0.82)	(2.30)	1.44
Real Estate	0.84	(7.37)	7.44
Money Market	0.15	0.53	0.44
S&P 500	**0.37**	**(0.42)**	**14.36**
Money Market	**0.15**	**0.53**	**0.44**

Stocks showed some minor growth, as U.S. stocks gained 0.38 percent. Both large and smaller cap stocks participated in the upturn. International stocks had a better gain, up 0.83 percent. Compared to U.S. stocks, some investors still see more value in foreign markets than ours. Real estate bounded back from a very weak quarter to gain 0.82 percent. As discussed more below, the changes in interest rates continue to hold back this investment. Bond suffered the largest loss, down 0.82 percent at the 10-year Treasury attempted to breach the psychologically important 3.0 percent level.

The increase in interest rates has a negative impact on the value of bonds. We have had several readers ask how that works, so we want first to give a quick, simplified example: Bonds are issued with

a set maturity date and a set interest rate. Imagine a company issues a bond set to mature on January 1, 2025, paying an interest rate of 5 percent. If an investor buys $10,000 of the bonds, she knows she will get her money back on that date, plus $500 interest each year.

Next, suppose two months later interest rates increase to 5.5 percent for bonds that mature in early 2025. The change in interest rates may be due to investors anticipating better economic activity in the future which implies possible increased borrowing and/or increased inflation. Or, it may be that the Federal Reserve believes it needs to stay ahead of inflation pressures and thus needs to increase short-term interest rates, which may then indirectly increase longer-term rates. If the owner of the first bond now wants to sell, she will have to set the price so that its annual interest payment is equal to the new higher rate. She will have to accept a price of $9,090. This is arrived at, in our very simplified example, by knowing that $9,090 times the 5.5 percent interest rate equals $500, or what the bond actually will pay.

If one anticipates holding the bond to when it matures, these daily market changes are less important. You will get your $10,000 back when it matures. However, if rates keep going, you lose the opportunity to earn higher payments by keeping the bond with the lower interest rate; this called an opportunity cost. This cost can be significant if the bond maturity rate is a long way off, and rates continue to climb. Thus, some investors will seek to sell now and avoid this cost.

Lastly, bond rates are set by supply and demand, particularly in the Treasury markets. If the supply of bonds increases because the Treasury needs to issue more bonds to cover expenses, then the price will generally decrease and interest rates will increase. The extent to which this happens also depends on a myriad number of other factors; it is also academically argued that we do not know for sure how much this impacts rates. It is still a factor to keep in mind, particularly as the Treasury announces the need to borrow more in 2018.

In sum, it is difficult to paint a scenario where interest rates start to go back down and bond prices increases. It is rare for bonds to have a losing year; we may be in such a year for 2018. The implication is to go to shorter-term bonds to protect principal; shorter maturities are not as impacted as longer-term bonds. Second, cash may actually return as a viable investment. Money market funds are the ultimate short-term bond fund and are structured to greatly reduce the chance of loss. One can ask why try to earn three percent and risk capital loss in a bond fund when a money market fund is paying 1.85 percent (Vanguard Prime Money Market.)

The secondary impacts show up in weaker stock prices. Higher interest rates make other investments more competitive and actually less risky than stocks. For example, one can earn the above noted 1.85 percent in a Vanguard money market or elect to earn a 1.92 percent dividend from Vanguard Dividend Appreciation Index and accept stock market risk. For a long-term investor, one would naturally look to the stock fund. But, what about someone who wants a secure income? That may explain the 0.23 percent loss in the Dividend Appreciation Index year to date.

As always, we welcome your thoughts and comments.

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