

# Bonds for the Long Term

January 27, 2010

In a present low yield environment, many fixed income investors are questioning whether it is a good time to invest in bonds. By their nature, the prices of bonds react inversely to the changes in interest rates; therefore, if interest rates rise, the price of the bond will fall. Specific security characteristics such as duration, call provisions, credit quality and convexity may make one bond's price fluctuations more volatile than another's. In general, the above rule holds true for most fixed income securities.

To better understand the relationship between changes in interest rates and bond price volatility, we examined historical quarterly returns for various Barclays Indices. **Based on our analysis, we believe that a rise in interest rates may not have as negative an impact on diversified fixed income annualized total returns over a three-year time horizon. Coupon income provides a "cushion" which partly mitigates the impact of declining prices. Moreover, we are of the opinion that rising interest rates do not necessarily lead to negative total returns over shorter time periods for diversified fixed income portfolios.**

We reviewed the quarterly return data from various Barclays Indices. For the purposes of this commentary, we focused on two primary indices -- the Barclays 10-Year Municipal Index and the Barclays Aggregate Bond Index. As a proxy for interest rate changes in the bond market, we used changes in the 10-year Treasury Yield. In line with our expectations, the negative return quarters were accompanied by an upward shift in the 10-year Treasury Yield. Conversely, declines in the 10-year Treasury Yield were associated with positive returns. The following four charts show the correlation between increases in the 10-year Treasury Yield and the quarterly Index returns. Furthermore, they illustrate that the number of negative Index return quarters is significantly less than the periods where the 10-year Treasury Yield rose.

- Over the past 29 year period, the 10-Year Barclays Municipal Index has experienced 28 negative return quarters, while the 10-year Treasury Yield rose in 60 quarters. (See chart 1.)
- Over the past 34 years, the Barclays Aggregate Index has experienced 31 negative quarters, while the Treasury Yield has risen in 72 quarters. (See chart 2.)

A review of the quarterly rolling 3-year time-weighted annualized returns for the indices highlights the benefits of a long-term fixed income investment strategy:

- During the past 27 years, the 10-Year Barclays Municipal Index has experienced positive returns for all quarterly rolling 3-year time periods. (See chart 3.)
- The Aggregate Index has experienced only two 3-year periods where the annualized returns were negative. (Returns during these two periods were modestly negative but are worthy of mention since they represent periods when rates increased dramatically. In both 3-year periods, rates rose over 500 basis points in an attempt to stifle inflation.) (See chart 4.)

## In Summary

While there may be a number of quarterly or annual periods of negative performance, a 3-year time horizon has historically, with two extreme exceptions, resulted in positive returns. In large part, this can be attributed to the fact that income and reinvestment represent a significant component of total return, which tends to mitigate the impact of adverse price movements. This theory is consistent with McDonnell's philosophy that a commitment to fixed income securities should be a long-term strategy compatible with the investor's time horizon and volatility tolerances.

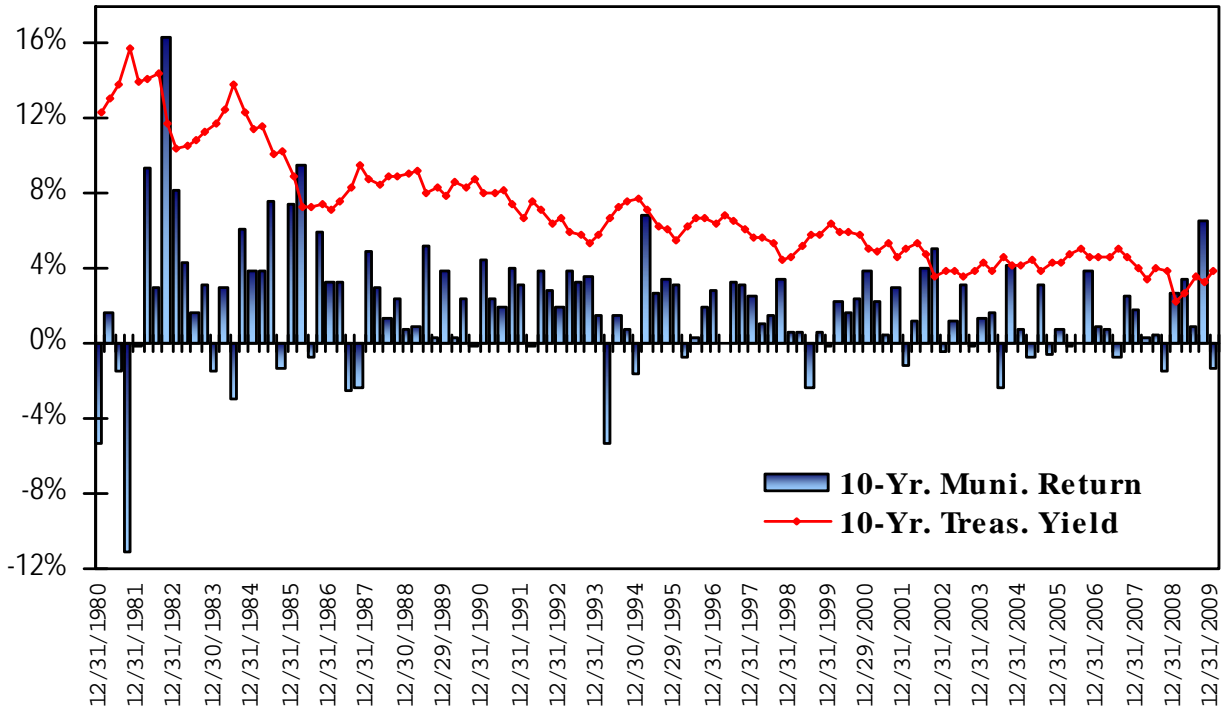


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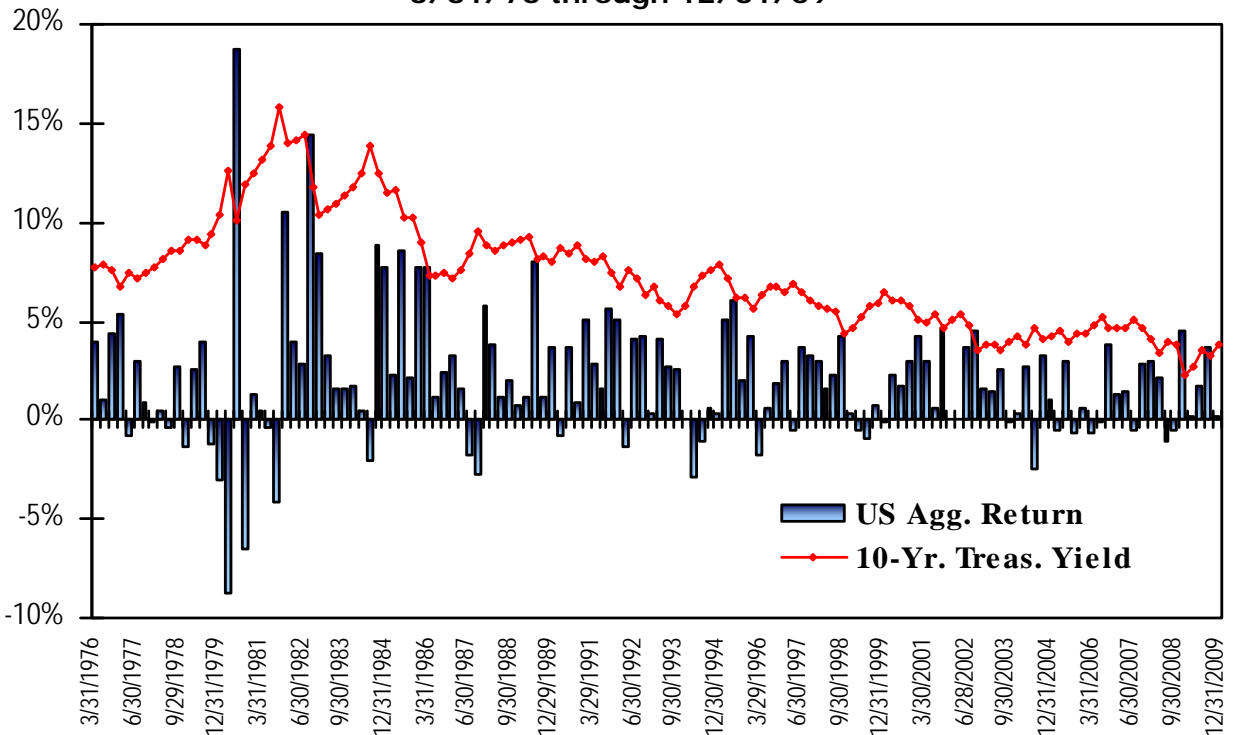
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**CHART 1:**  
**10-Year Municipal Return\* vs. 10-Year Treasury Yield**  
**12/31/80 through 12/31/09**

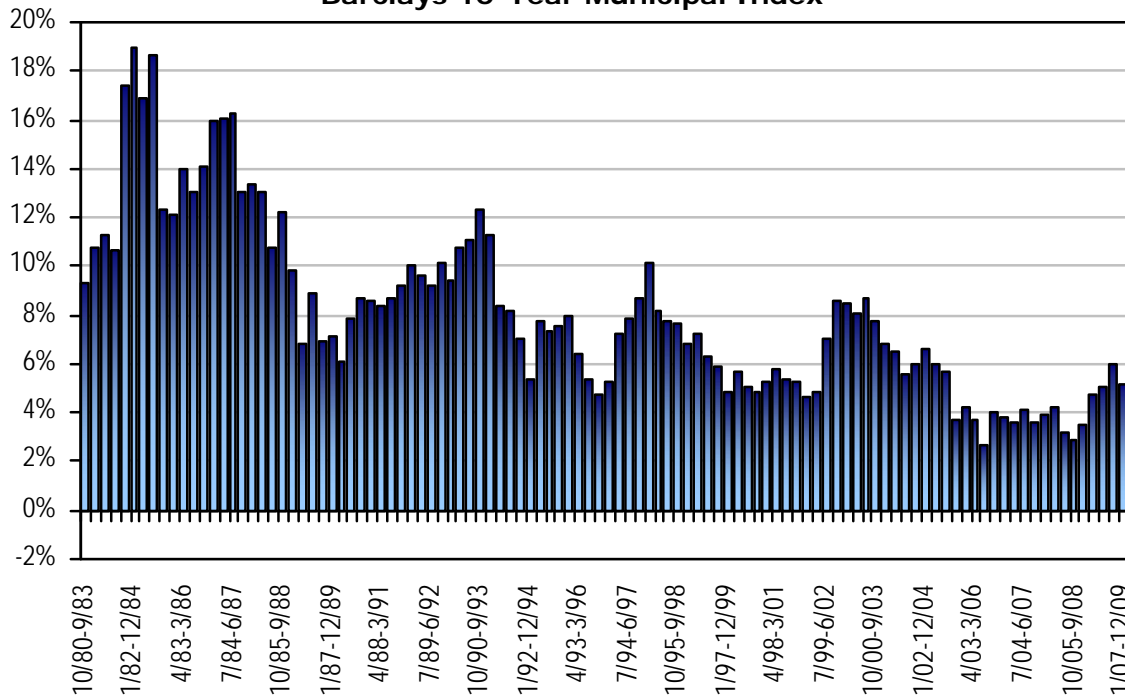


**CHART 2:**  
**U.S. Aggregate Returns\* vs. 10-Year Treasury Yield**  
**3/31/76 through 12/31/09**

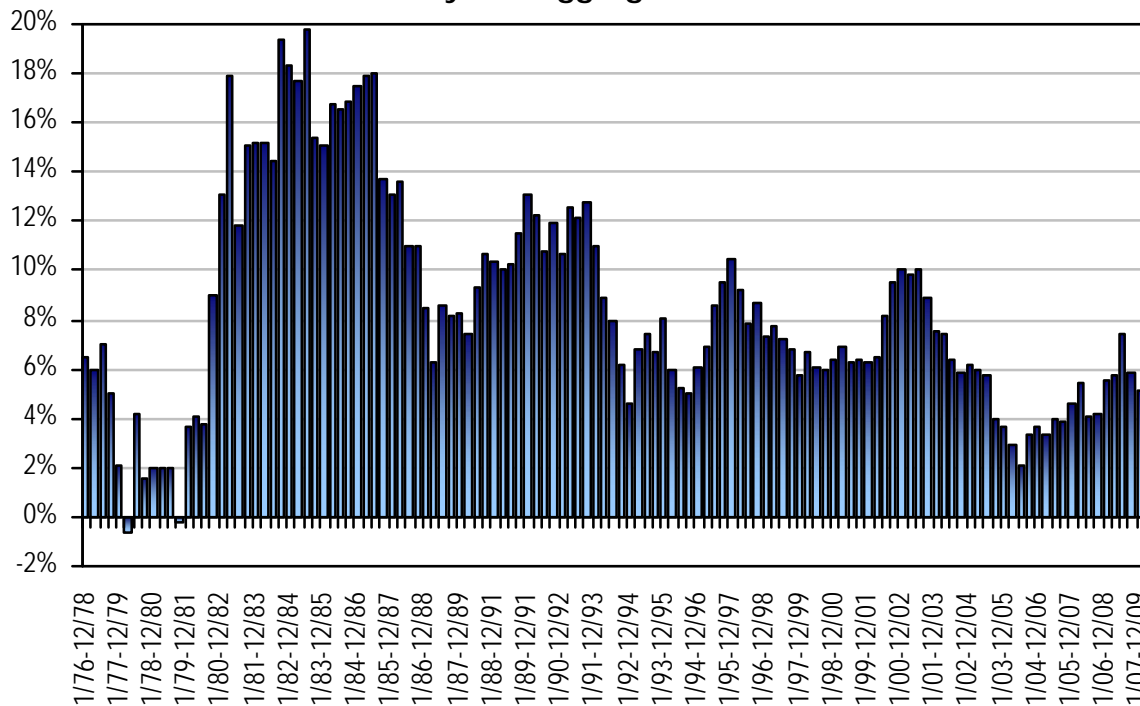


\* The return data for the Barclays Indices was analyzed based on the time period of index inception through 12/31/09. The indices are unmanaged and do not reflect any fees or expenses, but include the reinvestment of dividends/interest and other earnings. McDonnell believes the data to be reliable but does not make any representations as to its accuracy or completeness. It is not possible to invest directly in the Index. Source: Barclays and Bloomberg.

**CHART 3:**  
**3-Year Time Weighted Annualized Returns through 12/31/09**  
**Barclays 10-Year Municipal Index**



**CHART 4:**  
**3-Year Time Weighted Annualized Returns through 12/31/09**  
**Barclays US Aggregate Index**



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