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Western Asset's John Bellows Brings Graduate School Bond Math Insights to 2016 Legg Mason Investor Day

Fed Expert Says Rising Rates Aren't Bad for Bond Portfolios

Pasadena, Calif., Feb. 8, 2016 – It's on everybody's minds: are Fed rates going to continue to go up? There are currently two sides of the landscape – rates will continue to rise or the Fed's next move will be quantitative easing ("QE").

Links to Videos:

PART ONE:

<https://www.youtube.com/watch?v=QrfKjfw5Eos&feature=youtu.be>

PART TWO:

<https://www.youtube.com/watch?v=9UMkzjrEWOY&feature=youtu.be>

During Legg Mason's 2016 Investor Day, John Bellows Ph.D., Western Asset Portfolio Manager and Research Analyst, pushed back on the misconception that rising rates are bad for bond portfolios. He noted that the common belief is that if rates go up; bond prices go down. Most are taught in elementary bond school that a typical bond portfolio has sensitivity to interest rates of about four years. Thus if the Fed raises interest rates by 100 basis points, or 1 percentage point, the Assets Under Management ("AUM") of that portfolio is going to go down by 4 percent.

He said, "That gives you the wrong answer – a profoundly wrong answer. It misses several things. First and foremost, it misses the fact that bonds are income instruments. Not only do we care about the price change of the underlying principal, but income comes from holding a bond. What investors should care about is not that instantaneous price change; they care about the total return over the course of a year."

Bellows said that the second reason the elementary bond math leads investors to the wrong conclusion due to the idea that "as bonds get closer to maturity, they usually increase in value."

"A five-year bond today with a yield of 150 or 200 basis points is going to be a four-year bond a year from now; at that point it's going to have a four-year maturity with the same yield. That bond is more

valuable because it has a higher yield with a lower maturity. We call that 'roll down.' Appreciation of the bond price over time is another tailwind to offset some of that instantaneous spread increase."

Taking those first two, which Bellows noted is graduate school bond math, a 4 percent instantaneous decrease in the bond price is offset by a 2 percent coupon. That can also be offset by an increase in the principal amount just because you are getting closer to the maturity date.

Those two very powerful forces will, to a large extent, mitigate the impact of rising rates.

"Third is the importance of credit spreads. The bond portfolios we manage generally are not Treasury portfolios. They tend to be broad market portfolios, sometimes even credit portfolios, where the income on the bonds is substantially higher than Treasury bond income. Because the bond is an income instrument, there's a lot of coupon and a lot of income that offsets instantaneous price changes. That is especially true of a broad market portfolio," Bellows said, giving the third supporting point to his thesis.

Bellows stated that the yield curve shape is his fourth proof point as to why a rising rate environment is not bad for a bondholder.

He said, "When investors think about the Fed raising interest rates, many think all bonds are going to go up by 100 basis points. That's simply not true. What we've seen in history is the front end of the yield curve will increase pretty mechanically. The Fed governs the front part of the yield curve. But the back end of the yield curve, which is really what you care about if you have a long-dated bond, is unlikely to increase nearly as much."

Bellows reported, "The last time the Fed was raising rates in 2004 short-term rates went up by about 300 basis points. Five-year interest rates went up by less than 100 basis points. That emphasizes that the bond prices you care about are much less sensitive to the Fed than you may think."

Adding those four factors together, it is clear that rising rates can have dramatically reduced impacts on bond portfolio AUMs.

Bellows observed, "in almost all scenarios, bond portfolios increased in value over the course of a year. Yet not in a single year of those 10 did the five-year Treasury bond have a negative total return. During the 1970s, one of the biggest bear markets for bonds since we have data, interest rates went from about 4 percent at the beginning to 18 percent at decade's end. That is a huge increase: 12 percentage points over the course of 10 years."

"Yet in not a single year of those 10 did the five-year Treasury bond have a negative total return. Why? The market had priced in to some extent that rates were going to increase. That was reflected in the coupons, and in the roll down. Those factors offset the fact that rates went up."

Turning to Western Asset, Bellows notes that the firm's AUM isn't driven by rate changes, but rather, how the firm performs relative to benchmarks and relative to its competition. The last time the Fed raised rates in 2004, Western Asset outperformed our benchmark in almost all of its composites.

Bellows notes, "That was true again in 2005, when 70 percent of our composites outperformed the benchmark. From a competitive standpoint, we had very strong relative performance in 2004 and

2005. It was unambiguously positive for our business: AUM grew steadily, the number of clients grew, and the number of accounts grew.”

“I’m not a sales guy, so I’m not usually asked to talk about the fact that Western Asset has been nominated for two Morningstar Manager of the Year awards, and we won in 2014. But that is a strong vote of confidence,” Bellows continued. “What Morningstar and other investors recognize is that Western Asset’s broad portfolios over the last few years are ranked quite favorably versus our peers. When the market is off, even in periods of strong risk, our diversified strategies, which have different macro hedges to offset some of the credit, have been able to manage downside volatility.”

When pivoting to talk about the next rate increase and the pace of future increases, Bellows was measured in his prediction.

“I don’t think rates are going up that much. Maybe that’s not a surprise, but we do not fundamentally see a case for a sustained bear market in bonds. The most powerful argument is that the inflationary landscape in the United States and globally is extraordinarily subdued. Wage growth in the U.S. has been stagnant since the start of the recovery. Oil prices are obviously under pressure. The dollar is stronger. Core Consumer Price Index (“CPI”) is running at 2 percent but headline inflation has been close to zero.”

“At the end of 2014¹, something like one-third of all advanced economies were in outright deflation. Not only did we not have an inflationary scare, but instead we are experiencing a deflationary shock around the world.”

Why does that matter? Bellows says, “Bond yields, at some level, are a reflection of inflation. As long as inflation remains low, there’s almost no chance that bond yields are going to increase. When inflation is increasing – as in the 1970s, which generated that bear market – bond yields increased. When inflation is low, central banks are very engaged; it keeps them accommodative. It makes sure central banks will keep their reference rates low in order to support the economy. It prevents, or at least is likely to slow down, any central bank from thinking about raising rates.”

“The Fed hiked rates once; they are thinking about hiking rates again sometime this year. I’m going to punt on whether it will be March or later. I think they will probably follow through with it sometime later this year. The main thing to keep in mind now is when the Fed is raising rates, they’re going to do so extraordinarily gradually because inflation is so low, in the U.S. and around the world.”

“There is simply no reason for the Fed to raise rates. We think the Fed is likely to do maybe one, maybe two hikes this year. If the economy really takes off, maybe they will do three. Even three will put them on a tremendously slower pace than previous rate hike cycles.”

When outlining past hiking cycles, Bellows notes that they were much more aggressive.

¹ **Morningstar 2014 U.S. Fixed-Income Fund Manager of the Year** Awarded to Ken Leech, Carl Eichstaedt and Mark Lindbloom for Western Asset Core Plus Bond Fund (WAPSX) named Morningstar 2014 U.S. Fixed-Income Manager of the Year, United States of America. Morningstar Awards 2015 © Morningstar, Inc. All rights reserved. Morningstar Fund Manager of the Year award recognizes portfolio managers who demonstrate excellent investment skill and the courage to differ from the consensus to benefit investors. To qualify for the award, managers’ funds must have not only posted impressive returns for the year, but the managers also must have a record of delivering outstanding long-term performance and of aligning their interests with shareholders’. The Fund Manager of the Year award winners are chosen based on Morningstar’s proprietary research and in-depth evaluation by its fund analysts.

In 2004, they were hiking eight times a year. In 1994, not only were they hiking at a pace of 8 times a year, they were hiking 50 basis points at a time.

The low inflationary environment which keeps bond yields low in and of itself will also keep the Federal Reserve accommodative. Bellows believes that the Fed will make sure that any rate hikes will be slow, they will be measured, and you're not going to see any surprise in the upside.

Bellows concluded that it's not whether rates are higher or lower; rather the focus should lie with relative performance, the ability to add value in a risk-adjusted way over a cycle.

He ended his presentation by stating: "Rising rates are an important concern, but the main message is that rates aren't going up that fast. Those who are worried about rising rates do not share our outlook, frankly. If you recognize the global disinflationary pressure, you will be a lot more relaxed about this fear of rising rates."

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About John L. Bellows Ph.D.

John Bellows joined Western Asset Management in 2012 as a portfolio manager/research analyst. From 2009 to 2011 he served in the U.S. Department of the Treasury in three capacities: Acting Assistant Secretary for Economic Policy; Deputy Assistant Secretary for Microeconomic Analysis; and Senior Advisor in the Office of Economic Policy. Mr. Bellows earned a Ph.D. in economics from the University of California, Berkeley, and a B.A. in economics, magna cum laude, from Dartmouth College.

About Western Asset Management

Western Asset Management is one of the world's leading fixed-income managers with \$446.1 billion in assets under management as of September 30, 2015. The firm is a wholly owned, independently operated subsidiary of Legg Mason, Inc. From offices in Pasadena, Hong Kong, London, Melbourne, New York, São Paulo, Singapore, Tokyo and Dubai, the company provides investment services for a wide variety of global clients, across an equally wide variety of mandates. To learn more about Western Asset Management, please visit www.westernasset.com.

About Legg Mason

Legg Mason is a global asset management firm with \$671.5 billion in assets under management as of December 31, 2015. The Company provides active asset management in many major investment centers throughout the world. Legg Mason is headquartered in Baltimore, Maryland, and its common stock is listed on the New York Stock Exchange (symbol: LM).

DEFINITIONS:

The Federal Reserve Board ("Fed") is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

A **basis point** is one one-hundredth of one percent (1/100% or 0.01%).

A **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

The **Consumer Price Index ("CPI")** measures the average change in U.S. consumer prices over time in a fixed market basket of goods and services determined by the U.S. Bureau of Labor Statistics.

All investments involve risk, including loss of principal. Past performance is no guarantee of future results. Investments in fixed-income securities involve interest rate, credit, inflation and reinvestment risks; and possible loss of principal. An increase in interest rates will reduce the value of fixed income securities.

U.S. Treasuries are direct debt obligations issued and backed by the “full faith and credit” of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

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