COLUMBIA THREADNEEDLE INVESTMENTS

Income investing in a new interest rate regime

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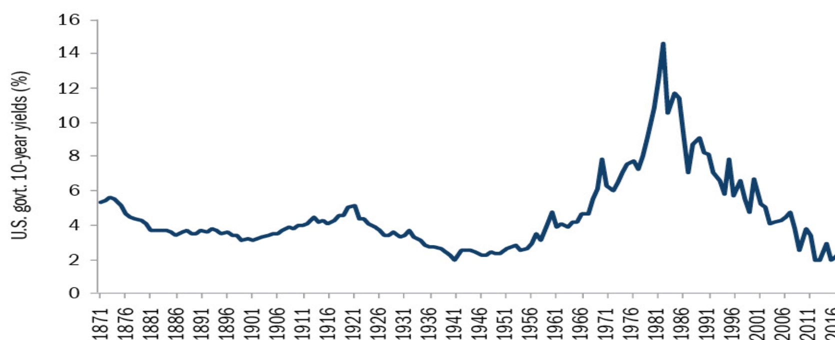
For four decades, investors have gotten a boost from falling interest rates. Now it's more important than ever to focus on reliability of investment income.

Investors have been through an extended period of unprecedented conditions, including four decades of declining interest rates, and it's important to appreciate just how unusual this environment has been. Historically, interest rates were fairly constant; from the late 1800s to the early 1900s, rates stayed in a range of about 3%–5.5%. It wasn't until after World War II that interest rates began to rise. And later in the 1970s, the Federal Reserve raised federal funds rates to 20% to combat rising inflation. This caused a severe recession in tne U.S., but it brought inflation under control. It also launched the extraordinary period of declining interest rates that may soon be comng to an end.

The best case scenario today is that rates remain low, but policy changes could drive interest rates higher. This new interest rate regime presents challenges for investors who rely on their fixed-income and equity investments to generate reliable income.

Exhibit 1: U.S. 10-year bond yields
1871–2017



Source: U.S. Treasury, "Irrational Exuberance," Robert Shiller, March 2000, Columbia Threadneedle Investments. Data as of 12/29/17.

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Fixed income: the end of a four decade bull market

The bond market nas actually been a relatively easy place to make money. Decreasing interest rates produced a prolonged bull market in bonds. In fact, from 1981 through 2016 when the bull market ended, the average annual gain in 10-year U.S. Treasury bonds was over 8% per year. There were double-digit returns in 13 of those years, and returns of over 20% in four of those years.

Now, the challenge for fixed-income investors is fairly intuitive: if interest rates go up, the price of bonds will go down. This means the coupon payment (or interest income) on bonds would be a signifcant part of fixed-income total return, and investors can no longer depend on declining interest rates and rising bond prices to prop up their fixed-income return.

With bond yields still very low, even small interest rate changes can result in significant income volatility and negative returns. For example, the exhibit below shows that If interest rates rose just 50 basis points [a basis point is 1/100 of a percent] a 10-year bond with a 2% yield would cause that yield to be wiped out.

HOW CAN YOU PREPARE?

GET THE WHITE PAPER

Learn:

- A strategy for the new interest rate regime.
- Why it is important to avoid dividend cuts.
- Ways other than interest rates to make money in fixed-income.

A small change in interest rates can have a big effect
(Assumes a 10-yearbond with a 2% starting field)

Hypothetical change in interest rates	+0.25%	+0.50%	+0.75%	+1.00%
One-year return	0.9	-1.1	-3.1	-5.0

Source: Columbia Threadneedle Investments

Equity: not immune to rising interest rates
For equity investors, the challenge may seem less obvious — there isn't as direct a connection between a change in interest rates and stock prices. But when interest rates rise, stock prices tend to decline and therefore, dividends become even more important because they compose a moresignificant part of total return. In recent decades dividends have accounted for less than 20% of the S&P 500 Index total return. However, from 1930 through 2017, a period that includes more typical interest rate environments, dividends contributed 42% of the S&P 500 total return.

	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010-2017	1930-2017
S&P 500 total return (%)	0.3	8.9	19.2	7.7	5.7	17.4	18.1	-1.0	13.8	9.7
% of return from dividends	N/A	66.6	29.3	43.1	72.0	27.5	15.6	N/A	16.2	42.0

Source: Ned Davis Research as of December 31, 2017, updated annually. Past performance is not a guarantee of future results.

The bottom line
After close to four decades of declining imerest rates, sourcing consistent income in a new rate regime presents unprecedented cnallenges. Understanding that interest rates are only one component of fixed-income return, and focusing on consistent and growing dividends rather than chasing high yields, may be a good way to prepare for this change. Read this white paper to learn more.

*Source: OECD, data as of 12/30/16. Columbia Threadneedle Investments. Past performance is not a garantee of future results.

Tre Standard & Poor's (S&P) 500 Index tracks the performance of 500 widley held large-capitalization U.S. stocks. It is not possible to invest directly in an index.

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