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Understanding Interest Rate Risk

With interest rates at historically low levels, many investors are concerned about what might happen to their bond investments if interest rates rise. This commentary will provide an overview of interest rate risk. Keep in mind that a bond mutual fund is simply a portfolio of bonds so it will be affected by changes in interest rates in the same way that an individual bond would be affected.

The most important thing to know about interest rate risk is that a bond's price typically moves in the opposite direction of interest rates. So, rising interest rates cause bond prices to fall and falling interest rates cause bond prices to rise.

Price/Interest Rate Relationship

Bond investments are very sensitive to interest rate changes.

There is an inverse relationship between bond prices and changes in interest rates

- As interest rates rise, bond prices fall
- As interest rates fall, bond prices rise



Generally, the longer a bond's maturity, the more sensitive it is to changes in interest rates. Long-term bonds, then, are viewed as having more interest rate risk than short-term bonds. While a bond's maturity is a good way to gauge interest rate risk, a bond's duration is a better way to do so. Duration is a statistic that measures the sensitivity of a bond's price to changes in interest rates. What makes duration so useful is this formula: for every 1 percent change in interest rates, a bond's price will change approximately 1 percent in the opposite direction for each year of duration.

Duration

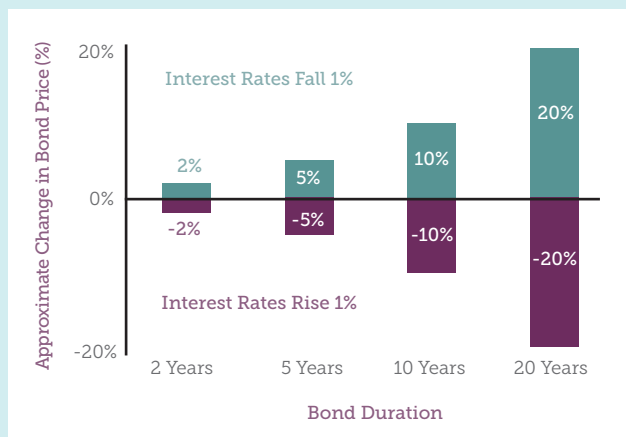
Duration is the best measurement of interest rate risk.

- Duration measures sensitivity of bond prices to changes in interest rates.
- For every 1 percent change in interest rates, a bond's price will change approximately 1 percent in the opposite direction for every year of duration.

(Continued)

Example

- A fund has a duration of 5 years
- If interest rates increase by 100 basis points (=1 percent)
- Then Fund's NAV will decrease by approximately 5 percent



As the above graph shows, bonds with longer durations are more sensitive to changes in interest rates. This means that, for a given change in interest rates, a bond with a

interest rates it can directly control. What frequently occurs in this case is that shorter-term rates go up notably more than longer-term rates:

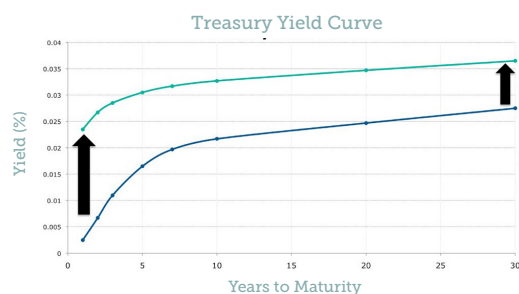
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This relationship is shown to the right. The arrow on the left side of the chart represents the movement in short term interest rates. The arrow to the left represents the movement longer term interest rates. As you can see the arrow representing short term interest rates is larger, which represents a bigger move in short term rates.

Interest Rate Risk and the Yield Curve



longer duration will typically have a larger gain (if interest rates fall) or a larger loss (if interest rates rise) than a bond with a shorter duration.

When looking at interest rate risk, investors sometimes also need to be aware of the yield curve. The yield curve shows different interest rates (or yields) for different bond maturities. When interest rates change, the shape of the yield curve often changes because some interest rates rise or fall more than others. At certain times, interest rates at different points of the yield curve have actually moved in the opposite direction! This can occur because different factors sometimes affect different parts of the yield curve. A good example is when the Federal Reserve (the Fed) is tightening monetary policy. The Fed does this by raising short term interest rates, which are the only

So, in this example, shorter-term bonds could suffer larger losses than longer-term bonds despite the former's lower duration.

To summarize some key points:

- Long-term bonds are more sensitive to changes in interest rates than short-term bonds.
- Duration is a good way to measure a bond's interest rate risk.
- Changes in the shape of the yield curve sometimes have a significant impact on bond returns.