A look back at history:

RISEING RATES AND THE BOND MARKET

Fixed income’s performance during past interest rate cycles offers valuable context for investors now.

• Historically, the income that bonds produce has offset the impact of rising interest rates on total return.

• Overall, fixed income delivered positive results during the past three Federal Reserve rate tightening cycles.

• History suggests there may be benefits to staying put and “riding out” the cycle, instead of rushing for the exits or pursuing a market-timing strategy.

• Active management may benefit investors by providing the flexibility to play defense when rates are rising, as well as the expertise to capture value created amid price volatility.

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All investments involve risk, including possible loss of principal.

1 Performance measured by the Bloomberg Barclays 1–3 Month Treasury Bill Index, the Bloomberg Barclays Intermediate Treasury Index, the Bloomberg Barclays Intermediate U.S. Government/Credit Index and the Bloomberg Barclays U.S. Aggregate Index. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

Please refer to page 7 for a Glossary of Terms.

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Awaiting the next move

It’s been said that the only guarantee in bond investing is that interest rates will rise and interest rates will fall.

- The Fed has increased its target rate nine times since December 2015, but in early 2019 it signalled a pause to assess developments in the economy.
- Investors are closely monitoring growth and inflation data for indications of how many times, if any, the Fed might raise rates in 2019.

Surprising performance

An analysis of representative index performance provides interesting insight into what investors might expect when interest rates are rising.

- In the three most recent Fed tightening cycles (1994–1995, 1999–2000, 2004–2006), a positive total return resulted as coupon interest payments more than offset price declines.\(^2\)
- More importantly, index performance was solid across the entire interest rate cycle (defined here as the 12 months preceding the onset of Fed tightening to 12 months after the last rate hike).
- Performance was negative on just a few occasions during the most challenging part of the cycle: from the low in the benchmark 10-year Treasury yield to its high.

The active advantage

In our opinion, an actively managed bond approach offers the potential for a better return than passive index investing. So, while index performance was positive during recent Fed tightening cycles, professional management of diversified fixed-income investments could offer several important potential advantages:

- A degree of diversification that most investors in individual bonds cannot attain on their own.
- The ability to play defense when interest rates are rising, by managing duration, something that a passive index cannot do.
- The expertise to take advantage of values created in all sectors of the market through effective security analysis and sector rotation, potentially enhancing total return.

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\(^2\) Performance measured by the Bloomberg Barclays Intermediate Treasury Index, the Bloomberg Barclays Intermediate U.S. Government/Credit Index and the Bloomberg Barclays U.S. Aggregate Index. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.
A look back at past periods of Federal Reserve tightening provides valuable insight into what investors might expect as the current cycle plays out.

The 2004–2006 Federal Reserve tightening cycle
Rates rose...

- The Fed raised the federal funds rate from 1% to 5.25% between June 2004 and June 2006.
- The 10-year Treasury yield oscillated in a fairly tight range between 4.58% when the Fed started raising interest rates and 5.13% when it stopped.

...And the results were...

- Positive total returns during the Fed’s tightening cycle.
- Positive total returns from the low to high in the 10-year Treasury yield.
- “Riding it out” resulted in solid returns, with the most diversified index producing the best results.  

Source: Bloomberg. Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.
The 1999–2000 Federal reserve tightening cycle

Rates rose...

- The Fed raised the federal funds rate from 4.75% to 6.5% between June 1999 and May 2000.
- The 10-year Treasury yield increased from a low of 4.42% in October 1998 to a peak of 6.66% in January 2000.

...And the results were...

- Positive total returns during the Fed’s tightening cycle.
- Mixed performance from the low to high in the 10-year Treasury yield.
- “Riding it out” resulted in positive returns across the entire interest rate cycle.  

Comparative total returns (%)

<table>
<thead>
<tr>
<th></th>
<th>Treasury bills</th>
<th>Intermediate Treasuries</th>
<th>Intermediate Gov/credit</th>
<th>U.S. aggregate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fed tightening cycle</td>
<td>4.9</td>
<td>3.1</td>
<td>2.4</td>
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<tr>
<td>10-yr yield low to high</td>
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<td>-0.3</td>
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<td>Riding it out</td>
<td>16.7</td>
<td>20.2</td>
<td>20.6</td>
<td>20.0</td>
</tr>
</tbody>
</table>

Source: Bloomberg. Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

5 From June 1999 through May 2000, the months when the Fed was actively raising interest rates, the Bloomberg Barclays 1–3 Month Treasury Bill Index returned 4.9%, the Bloomberg Barclays Intermediate Treasury Index returned 3.1%, the Bloomberg Barclays Intermediate Government/Credit Index returned 2.4% and the Bloomberg Barclays U.S. Aggregate Index returned 2.4%. From October 1998 through January 2000, the period when the 10-year yield rose by 224 basis points, the Bloomberg Barclays 1–3 Month Treasury Bill Index returned 6%, the Bloomberg Barclays Intermediate Treasury Index returned 0.1%, the Bloomberg Barclays Intermediate Government/Credit returned 0.4% and the Bloomberg Barclays U.S. Aggregate Index returned -0.3%. From June 1998 (a year before the Fed began tightening) to June 2001 (a year after the Fed stopped tightening), the Bloomberg Barclays 1–3 Month Treasury Bill Index returned 16.7%, the Bloomberg Barclays Intermediate Treasury Index returned 20.2%, the Bloomberg Barclays Intermediate Government/Credit returned 20.6% and the Bloomberg Barclays U.S. Aggregate Index returned 20%.

6 Reflects performance from the month when 10-year Treasury yields were at a low for the cycle through the month when they peaked for the cycle.
The 1994–1995 Federal Reserve tightening cycle

Rates rose...

- The Fed raised the federal funds rate from 3% to 6% between February 1994 and February 1995.
- The 10-year Treasury yield increased from a low of 5.38% in September 1993 to a peak of 7.90% in November 1994.

...And the results were...

Comparative total returns (%)

- Positive total returns during the Fed’s tightening cycle.
- Modest declines from the low to high in the 10-year Treasury yield.
- “Riding it out” resulted in solid returns, with more diversified indexes producing better results.8

Source: Bloomberg Barclays. Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

Footnotes:
1 Reflects performance from the month when 10-year Treasury yields were at a low for the cycle through the month when they peaked for the cycle.
8 From February 1994 to February 1995, the period when the Fed was actively raising interest rates, the Bloomberg Barclays 1–3 Month Treasury Bill Index returned 4.6%, the Bloomberg Barclays Intermediate Treasury Index returned 2.2%, the Bloomberg Barclays Intermediate Government/Credit returned 2.2% and the Bloomberg Barclays U.S. Aggregate Index returned 1.8%. From September 30, 1993 to November 30, 1994, the period from the low in 10-year Treasury yields to the peak in 10-year Treasury yields, the Bloomberg Barclays 1–3 Month Treasury Bill Index returned 4.4%, the Bloomberg Barclays Intermediate Treasury Index returned -1.9%, the Bloomberg Barclays Intermediate Government/Credit Index returned -2.1% and the Bloomberg Barclays U.S. Aggregate Index returned -3.5%. From February 1993 to February 1996, the Bloomberg Barclays 1–3 Month T-bill Index returned 11.5%, compared with 17.4% for the Bloomberg Barclays Intermediate Treasury Index. The more diversified Bloomberg Barclays Intermediate Government/Credit Index and Bloomberg Barclays U.S. Aggregate Index did even better, up 18.44% and 20.41%, respectively.
Periods of rising interest rates are a normal part of bond investing, but that doesn’t mean that they don’t create anxiety. However, before making any impulsive moves out of fixed income, you should carefully consider the risks involved in attempting to time moves in and out of the market, including the potential for unwanted taxable events. As you can see from the examples from the previous pages, “riding it out” has made sense in the past.

Yet, these only reflect the performance of passive indexes. While active management and diversified approaches do not guarantee superior or positive performance, we firmly believe they provide the following potential performance-enhancing benefits that are not accessible with passive investments:

**Experience**
Professional management offers access to lessons learned during past cycles.

**Diversification**
Most individual investors do not have the buying power or the access to the issues necessary to properly diversify across multiple issuers, sectors, industry groups, countries and currencies. Diversification does not guarantee a profit or protect against loss.

**Research and analysis**
Actively managed approaches give individual investors access to individual security analysis and sector rotation skills that can enhance the opportunity for growth through a focus on total return instead of just yield.

**Flexibility**
Professional management provides the ability to quickly respond to opportunities in the market that can arise abruptly for many different reasons.

**Risk management**
Including duration management, yield curve positioning and ongoing monitoring and portfolio restructuring based on changing conditions.
**Investment risks**

The opinions and views expressed herein are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, or investment advice.

Fixed income securities are subject to interest rate and credit risk, which is a possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. As interest rates rise, the price of fixed income securities falls.

Diversification does not assure against market loss.

Outperformance does not imply positive results.

Active Management does not ensure gains or protect against market declines.

There is no guarantee objectives will be met.

**DEFINITIONS:**

The **Bloomberg Barclays 1–3 Month Treasury Bill Index** is the 1–3 months component of the U.S. Treasury bills index. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

The **Bloomberg Barclays Intermediate Treasury Index** is the intermediate component of the U.S. Treasury index. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

The **Bloomberg Barclays Intermediate Government/Credit Index** is a market value-weighted performance benchmark for government and corporate fixed-rate debt issues (rated Baa/BBB or higher) with maturities between one and 10 years. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

The **Bloomberg Barclays U.S. Aggregate Index** is a broad-based bond index consisting of government, corporate, mortgage and asset-backed issues rated investment grade or higher and having at least one year to maturity. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

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

**Duration** is the measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. Calculation is based on the weighted average of the present values for all cash flows.

The **U.S. Federal Reserve**, or **“Fed,”** is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

The **federal funds rate** is the interest rate that banks with excess reserves at a U.S. Federal Reserve district bank charge other banks that need overnight loans.

**Gross domestic product**, or **GDP**, is the total market value of all final goods and services produced in a country in a given year.

**Maturity** refers to the date on which the principal is required to be paid on a bond.

**Quantitative easing (QE)** refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

A **Treasury bill** is a negotiable debt obligation issued by the U.S. government and backed by its “full faith and credit,” and which has a maturity of one year or less.

A **Treasury note** is a negotiable debt obligation issued by the U.S. government and backed by its “full faith and credit,” and which has a maturity of one to 10 years.

**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. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

The **U.S. Treasury Department** is responsible for issuing all Treasury bonds, notes and bills; it is responsible for the revenue of the U.S. government.

The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.
IMPORTANT INFORMATION:

All investments involve risk, including possible loss of principal.

The value of investments and the income from them can go down as well as up and investors may not get back the amounts originally invested, and can be affected by changes in interest rates, in exchange rates, general market conditions, political, social and economic developments and other variable factors. Investment involves risks including but not limited to, possible delays in payments and loss of income or capital. Neither Legg Mason nor any of its affiliates guarantees any rate of return or the return of capital invested.

Equity securities are subject to price fluctuation and possible loss of principal. Fixed-income securities involve interest rate, credit, inflation and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls.

International investments are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets.

Commodities and currencies contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

Past performance is no guarantee of future results. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

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