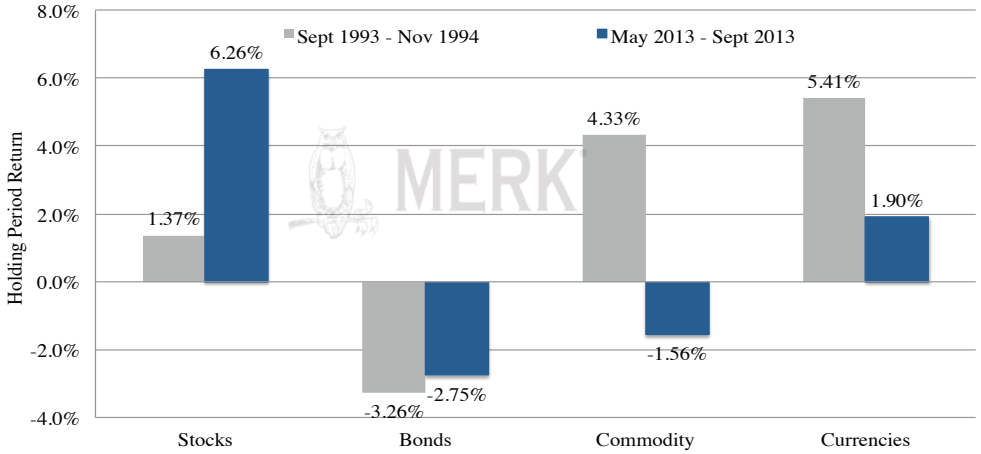
Now that the 30-year secular interest rate decline may have come to its much-touted end, how should we invest? The concern over rising interest rates has become a hot topic and for a good reason.

Manage Bond Risk & Include Alternatives

We see two action items for educated investors: active risk management within a fixed income allocation and building a more diversified portfolio that includes alternative assets. These may provide investors with improved risk-returns as we head into a period of rising interest rates.

Figure 2: Asset Classes Performance In Periods of Rising Rates*



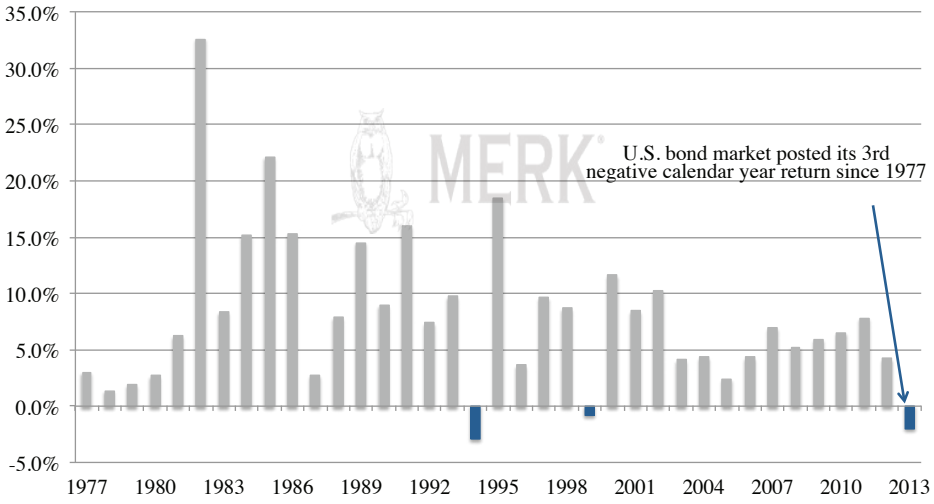
Source: Merk Investments, Bloomberg
* Holding period returns (not annualized); rising rates as measure by long-term Treasury yields
Stocks: S&P 500 Total Return Index. Bonds: Barclays U.S. Aggregate Bond Index
Commodities: Deutsche Bank Liquid Commodity Index. Currencies: Inverse Dollar Index

Bond Market at a Turning Point?

In contrast with the stock market's stellar performance, 2013 marked the first negative return since 1999 for the U.S. bond market. Figure 1 shows the Barclay's U.S. Aggregate Bond Index's annual returns since its inception in 1977.

Down the road, market expectations of higher interest rates could put persistent pressure on bond prices. Adding to the risk, current bond yields are near historical lows and seem to have nowhere to go but up. With the yields near record lows, the income bonds generate may not be sufficient to offset the loss from a price decline due to rising interest rates, and could ultimately hand the investor a negative total return.

Figure 1. U.S. Bond Market Annual Return*



Source: Merk Investments, Bloomberg, Barclays Capital
* Measured by Barclays U.S. Aggregate Bond Index
Period: Jan. 1, 1977 - Dec. 31, 2013

Are Bonds Safe?

With this backdrop, investors should take a close look at the risks associated with the fixed income component of their portfolios. Bonds are traditionally considered a "safe" haven compared to riskier stocks in their long-term asset allocation. Given the current market circumstances, investors may agree that interest rate risk poses the primary threat to most fixed income portfolios.

How Do Alternatives Perform When Rates Rise?

If bonds continue to be under pressure, especially in a rising interest rate environment, where should investors turn for diversification and downside protection? We suggest looking into alternatives. In previous periods of rising interest rates several alternative asset classes outperformed bonds. Figure 2 captures the performance of select asset classes during two periods of rising interest rates: from September 1993-November 1994 and the very recent May-September 2013 period.

Alternatives to Provide Diversification

The table below summarizes some of the strategies for investors to consider when interest rates are rising.

The bond market faces significant interest rate risk that is exacerbated by a growing concentration in Treasuries, extended duration, and historically low yields.

We believe that, in addition to pursuing more active risk management within the fixed income space, investors should build a truly diversified portfolio. Alternative assets can be a valuable addition that will enhance a portfolio's overall risk-return profile in anticipation of rising interest rates. M

For more analysis, please sign up for Merk Insights at www.merkinvestments.com.

How to Invest When Rates Are Rising?

Strategy Within Bonds	Strategy With Alternatives
Short Duration • Pros: Low duration risk • Cons: Opportunity cost	Building a diversified portfolio with the inclusion of alternative asset classes: Pros: • Historically outperformed bonds when rates rose • Low correlation may add diversification benefits • May enhance the overall portfolio's risk-adjusted return Cons: • Potentially unfamiliar risks associated with alternative asset classes, e.g. foreign exchange risk • Potentially higher volatility or liquidity risk
Floating rate • Pros: Low duration risk • Cons: Liquidity risk	
High yield • Pros: Higher income • Cons: - Substantial credit risk - Liquidity risk - Equity correlation	
Nontraditional • Pros: Higher flexibility • Cons: - Strategies vary widely - Often traditional sub-strategies - May not deliver uncorrelated returns	

About Merk

Merk Investments, LLC is a leader in the currency asset class and a pioneer in providing uncorrelated returns and portfolio diversification through actively managed currency funds.

Axel Merk

Axel Merk is the Founder, President and Chief Investment Officer of Merk Investments.

Disclosure