Helpful Strategies for a Low Interest Rate Environment

With interest rates at extremely low levels, some financial advisors say bond investments currently present a more significant risk to investors than stocks. As the economy recovers, the Federal Reserve may have to raise interest rates at some point, which will inversely affect bond prices. Long-term bonds tend to lose the most value during interest rate increases so many financial advisors have been reducing their holdings in this area and instead, avoiding bonds or only recommending bonds that have short-term maturities.

An important piece of information for bond investors is a statistic known as "**duration**." In finance, the duration of a financial asset that consists of fixed cash flows, such as a bond, is the weighted average of the times until those fixed cash flows are received. Duration also measures the price sensitivity to yield, the percentage change in price for a parallel shift in yields. Simply said, the longer the duration, the more sensitive a bond will be to changes in rates.

Interest rate risk can be simplified by the following statement: when interest rates rise, bond prices fall. Conversely, when rates decline, bond prices rise. Therefore, the longer the time to a bond's maturity, the greater its interest rate is at risk.

Many investors often put a high percentage of their portfolios in bonds when they are very worried about the economy or other financial issues, or after they have taken a beating in stocks. Eventually, that concern subsides over time, only to be replaced by greed. That's when investors often spurn fixed income investments and start buying back stocks. Then, when another market cycle ends, many will get nervous again — and the fear-greed cycle repeats itself. Unfortunately, that's the way it usually works.

What Should the Prudent Investor Do?

Now is an ideal time to review or revisit your bond holdings to identify what, if any, changes you may need to make.

Bonds are an essential part of a conservative portfolio: they provide income and are usually more stable than stocks. If you are retired and relying on investment income to pay the bills, it's not appropriate to only invest in equities in most cases. Unfortunately, the Federal Reserve's recent strategy of keeping short-term rates near zero has made it nearly impossible to earn very much on your cash.

Ever since the global financial panic struck, many investors have been piling into Treasury bonds for one simple reason: the U.S. government is considered an entity where there is virtually no chance of default. Yet Treasury bonds aren't nearly as secure as many investors might think. You cannot ignore the risks in today's bond market. In fact, some investors believe we are in the middle of an inflating bond bubble that is soon to pop.

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3 Basic Strategies to Consider Discussing with Your Financial Advisor to Prepare for Rising Interest Rates

1 Consider Adjusting Your Interest Rate-Sensitive Holdings

If you hold any interest rate-sensitive investments like bonds, you'll want to limit the chance that you'll be disappointed if interest rates rise. Take a look at your current portfolio and discuss with your financial advisor how rising interest rates could affect your positions. Rethink your assumptions when analyzing new positions, and be sure to manage expectations for cash flow and principle values based on the effects of an interest rate increase.

2 Review Any Payments You Have That Are Interest Rate-Sensitive

The idea here is to save on interest payments by checking to see that any payments you are making on loans or borrowed monies are taking advantage of lower rates. If you're considering paying off or refinancing any mortgages or loans, don't forget to plan for your cash needs in order to avoid putting yourself in a jam down the road.

3 Review Your Cash Reserves

It has often been said that "Cash is King" and "as long as you have enough of it to make your payments, you can weather just about any financial storm." If appropriate, having access to cash can help keep your options open.

In today's low interest rate environment, the mentality of a traditional bond investor has drastically changed. The traditional view of investing in bonds for yield income has been replaced by investing in bonds for capital preservation. Investors now need to reconsider interest rate risk, issuer credit risk, and purchasing power risk. Under Chairman Ben Bernanke, the Fed is keeping interest rates super low to encourage investment in houses, factories, equipment, and software and to make it easier for households to keep spending as they pay off their debts.

Let's take a quick look at long-term bonds. Since 1980, their yields have dropped from 15.2% to 3.2% (as of March 2013). If interest rates on those Treasury Bonds increase to 5%, a 30-year Treasury could drop in current value over 10%. That's a significant amount of risk with what is supposed to be your "safe stash." This year, many experts say they believe that interest rates will rise because they see clear signs that the economy is finally getting up off the floor. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

If inflation starts to increase, the Fed may start to raise interest rates to keep inflation in check. As previously noted, when interest rates go up, bonds often go down in value. In fact, interest rates don't have to rise much for bond investors to realize substantial losses — even the fear of interest rates going up is often enough for the value of bonds to go down.

While Treasury bonds are less volatile than stocks and have features that stocks don't, bonds are far riskier than some investors appreciate. Interest rates are at their lowest levels since the 1950's. Investors who grasp for that last percentage point of yield and buy long-term bonds are making a gigantic bet that rates will fall even further or at least hold even. However, with rates this low, the question really may not be whether interest rates will rise, but when. Depending on the bond, an investor may still receive their investment back if they hold their bonds until maturity, but not in real terms (after inflation).

Q&A: ABOUT RISING INTEREST RATES

1 | When interest rates start to rise, how will that affect bonds?

Currently, interest rates are at historically low levels. Just as bond prices go up when yields go down, the prices of bonds you own now will generally drop as yields — interest rates — go up.

2 | When rates go up, do all bonds lose the same value?

No, changes in interest rates don't affect all bonds equally. Generally speaking, the longer the bond's maturity (for example, a bond that matures in 10 years versus another that matures in two years), the more it typically will be affected by changing interest rates. A 10-year bond will usually lose more of its value if rates go up than the two-year note. Also, the lower a bond's "coupon" rate, the more sensitive the bond's price is to changes in interest rates. Other features can have an effect as well: a variable rate bond probably won't lose as much value as a fixed rate security; however, it may present other risk factors.

3 | When interest rates rise, should I hold onto my bonds or sell them?

This is a strategy you will want to discuss with your financial advisor. If you buy a bond and hold onto it until it matures, which many investors do, rising rates won't have any effect on the income you receive. You simply redeem your maturing bond and get back the face value of the bond. In the meantime, you will continue to earn or accrue interest at the rate you expected when you bought the bond. Remember, you would need to consider the opportunity costs when reviewing the true return on that bond. Here's an example provided by Bloomberg, LP:

Buy and Hold
You buy a 10-year U.S. Treasury Note with a face value of $1,000 and an interest rate of 4.00%. If you keep the bond until it matures, you'll receive $40 each year for 10 years, plus the original $1,000.

4 | What happens if interest rates go up and I need to sell my bonds?

If interest rates go up and you need to sell your bonds before they mature, their value may have gone down and you may have to sell at a loss. Remember, bond prices move in the opposite direction as yield. Here's another example from Bloomberg, LP:

Sell Before Maturity and Interest Rates Have Gone Up
An investor buys a 10-year U.S Treasury Note with a face value of $1,000 and an interest rate of 4.00%. If the investor sells the bond before it matures and interest rates have risen 2%, he would only receive $874.39 (plus any interest paid before the sale).

5 | Besides rising interest rates, are there any other risks I should consider?

Yes, virtually all investments carry some degree of risk that you might lose some or all of your investment. Bond choices range from U.S. Treasury securities,backed by the full faith and credit of the U.S. government and free from credit risk, to bonds that are below investment grade and considered speculative. When investing in bonds other than government-guaranteed securities, it's important to remember that an investment's return is linked to its credit as well as market changes. Usually, the higher the bond's yield, the higher the risk. Conversely, highly rated bond investments offer relatively lower returns. In assessing your tolerance for risk, ask yourself, "What will I do if my investment is not there when I need it?"

6 | Should I buy bonds now?

Most financial advisors recommend investors have a diversified investment portfolio consisting of bonds, stocks and cash in varying percentages. You need to be aware of the risks, particularly now, of rising interest rates. However, if you are planning on buying high-quality bonds and holding them to maturity, they should provide a predictable stream of payments and repayment of principal. Many people invest in bonds to preserve and increase their capital or to receive dependable interest income (please remember that although you may achieve that objective, you run the risk of not keeping pace with inflation). Whatever your investment goals are, investing in bonds may be a part of how you achieve your objectives.

While reviewing interest rate risks sounds like a straightforward task, it can be much more complex. For example, there are nuances to reviewing duration including how to compare the different types of bonds such as investment-grade corporate bonds and treasuries. Just because they have the same level of duration does not mean that any two bonds will respond identically to interest rate changes. In the case of corporate bonds, their prices are also influenced by the credit quality of the company. This is where we can help you. We are constantly overseeing the investments we recommend to our clients. In today's interest rate environment, a review from a qualified financial advisor can prove to be a powerful experience. We are proud of the research we do on our clients' behalf and are always willing to offer a "complimentary" financial review for your family, friends and associates.

P.S. This is something that you should try not to procrastinate about. We strongly suggest that you have your investment portfolio reviewed to make sure you understand the advantages and disadvantages of keeping your portfolio exactly the way it is now. Remember the old saying, "If it ain't broke, don't fix it." However, how would you know it's not broken unless you have a qualified professional review it?

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