Rising Rates and Your Portfolio

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The topic of rising interest rates has consumed the financial media. One cannot escape the speculation about when rates will move higher. We do know the Federal Reserve has ended its easing policy and that an increase in the Federal funds rate will follow as soon as economic growth and the job market are on solid ground. When this will occur and the real impact on long term rates is not so clear. Predictions on timing keep getting pushed out as we wait for the Fed to make its move. With timing so uncertain, how can investors properly align their portfolios? It makes little sense to react to headlines; far better to be prepared.

From a broader perspective there are numerous ways an increase in rates can impact the markets. The magnitude of the impact is uncertain and depends on how quickly rates move up, what expectations are inherent in the market, and how U.S. rates compare to other global markets.

Housing market. As longer term interest rates rise it becomes more costly to purchase a home. Demand weakens and new home sales slow. This can trickle down to many other sectors of the economy, including businesses that supply materials for home construction and banks that see less loan activity.

Borrowing costs for businesses increase. Companies do plan and budget for higher borrowing costs, but if the rate of change is greater than expected it can cause businesses to put projects on hold, slowing growth for some companies.

Bond market. Interest rates and bond prices move in opposite directions. As interest rates in the market move higher, prices on existing bonds will decline. Older bonds offer interest rates that are lower than prevailing market rates; therefore prices on these bonds fall so that the yield to maturity equals that of newly issued bonds sporting current (higher), interest rates. The size of the price decline varies greatly

depending on the bond's maturity. Bonds with longer maturities are more sensitive to rising rates, while those maturing in a few years are less affected. Duration is a measure of a bonds sensitivity to interest rate moves. In general a 1% rise in rates will cause roughly a 1% decline in the price of a bond. If you own a fixed income mutual fund the fund's duration will provide a gauge as to how sensitive it is to rate moves.

Stock market effect can be varied because so many factors are at play. While it can be expected that economic growth will be strong enough for the markets to support higher rates, the market's reaction is also influenced by expectations. A rate rise will certainly come as no surprise at this point, and a slow gradual rise in rates is likely priced in. Still, the anticipation of higher rates in itself brings volatility to the market. Investors often try to get ahead of the rise and therefore sell during the time leading up to a rate hike. If interest rates move high enough that we see 5% rates on a CD for example, the risk-return dynamic changes as investors begin to reassess their desire to allocate so much to riskier assets such as stocks. Over the long term, it should be good for stocks as it indicates that corporate earnings are strong.

Considering all of these changing components what is the best way to protect your investments?

Investors should not react to headlines and rate predictions by reallocating stock and bond holdings. Decisions about asset allocation should be based on long term goals, aligned with one's risk tolerance and designed to protect the overall portfolio when market volatility occurs. For a long term investor a well-designed portfolio provides both growth and capital preservation. It should protect in times of market volatility brought on by such events as a rise in interest rates. Investors are encouraged to stay the course and rebalance regularly. However, there are a few things to consider when determining whether your portfolio is set up properly given today's rate environment.

Diversification is key. Balance holdings between stocks, bonds and cash to reflect long term goals and risk appetite. Vary bond holdings across different sectors and maturities. Reduce exposure to those bonds maturing beyond ten years. If you have conviction about higher rates, add some floating rate notes to the portfolio. Diversify your stock positions across sectors and add international exposure. International stocks typically outperform during a U.S. Fed tightening cycle. This

applies to bonds as well. Global bonds are influenced by another set of economic conditions and global rates, and may not be impacted in the same way as U.S. debt. International bonds add another level of diversity to a comprehensive bond portfolio.

Manage maturity. Selling all your bonds in fear of falling prices is not the answer, but it would be wise to shorten the maturity of the portfolio to temper any price fluctuation. It is also likely that with bond yields so low, investors have added riskier assets to their fixed income portfolio to add more yield or moved into high dividend paying stocks. Now would be a good time to pare back that exposure and move into more traditional types of fixed income instruments with a maturity target inside of ten years. If you are planning to hold bonds to maturity the rise in rates is not as critical.

Ladder your bond holdings. Another approach is to ladder your fixed income holdings. A strategy similar to dollar cost averaging, an investor invests in the bond market slowly. Bonds are purchased with consecutive maturity dates so that a portion is maturing each year; this provides liquidity and the ability to reinvest at the current interest rates. This is beneficial in a rising rate environment.

Equity exposure. When rebalancing, and adding equity exposure to the portfolio, focus on sectors that will benefit from higher rates such as financial and cyclical stocks. Earnings in the defensive sector are stable and should remain so even when rates are rising, so they can add some safety to the mix. That doesn’t mean to ignore the other sectors all together but to be prudent in looking for companies that offer value.