Rising Interest Rates Can Affect Your Portfolio
By Gary Case

In last week's column, I discussed some characteristics of bonds and how movements in interest rates can affect bond prices. Today's column will focus on specific strategies you can use to help protect your fixed income portfolio's value during a period of rising interest rates.

1. Ignore interest rate movements. A simple measure is to purchase a bond and hold it until it matures. If you don't sell a bond, any fluctuation in value will not impact you…you'll simple get your principal back when the bond matures. Of course, there are other risks to consider when applying this strategy, such as credit risk and business risk. Also, bonds are not the only fixed income option that can utilize this strategy. You might also consider, for example, preferred stocks or convertible securities.

2. Determine which types of bonds might be most affected by rising interest rates. Questions to consider include, "Do government bonds offer a yield advantage, considering they are high in credit quality?" or "Are intermediate maturity (or duration—see last week's column) at greater risk than short or long term bonds?

3. Use a "barbell" approach. One very common strategy in a rising rate environment is to use some very short-term bonds with some long-term bonds, virtually eliminating intermediate. The philosophy behind this strategy is that short term bond's value will be less affected by interest rate movements, and long-term bonds-- because of higher declared interest rates, as well as long maturities—could be less affected than intermediate-term bonds.

4. Buy "premium" bonds. These bonds currently sell at more than their face value because the interest rate declared on the bond (the coupon) is higher than current rates. These bonds tend to hold their value as interest rates rise.

5. Another vehicle is corporate bank loans that have been "securitized," or put together in a mutual fund or another investment form. Generally, look for rather short-term loans that re-set as interest rates rise. These securities can also tend to hold value in a period of rising interest rates

6. Use dividend paying stocks, real estate, equipment leasing, or other alternative income producing vehicles. Many times such investments can react differently than bonds to rising interest rates.

These are some, but not all, of the strategies that can be used to address interest rate risk. At this writing, bonds and bond funds have performed very well in 2004, so the question becomes, when is the right time to begin the process of interest rate risk mediation? As always, seek qualified advice before placing your hard-earned money into any investment strategy!

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