Rising Interest Rates and Your Investment Portfolio
By Gary Case

Recent talk from pundits, market watchers, and even the venerable Alan Greenspan indicates that interest rates will be rising, possibly sooner rather than later. In addition to the effects on consumers, savers, and debtors, a rising interest rate environment may affect how your investment portfolio behaves.

Most portfolios that use asset allocation have some money in income producing securities such as bonds, dividend paying stocks, real estate trusts, bank deposits, and annuities.

Bonds, probably the most common income generating security, are loans to governments or companies and current bond prices generally have a "teeter-totter" relationship with movements in interest rates. When rates move up, bond prices often move down. This occurs because high interest rates generate more income than low interest rates for each dollar invested. If a bond is held to maturity, current price is probably not an important consideration. But if a bond may be sold (and bonds in mutual funds and other managed portfolios often are), then a drop in the price of that bond becomes more of an issue.

Bonds come in many flavors, from US government to foreign government to corporate bonds issued by either US or foreign companies. Just as individuals have different credit ratings, so do companies and governments. Ratings firms such as Moodys and Standard & Poors perform research and assign a credit quality rating to bonds. A higher credit rating means that the research firm believes an investor will have a greater probability of receiving interest payments and a return of principal when the bond matures.

Another important characteristic of bonds is called "duration". While duration may sound like the length of time before a bond matures, it actually refers to a rather complex measure of price volatility in response to movements in interest rates. For instance, all other things being equal, the price of a bond, duration 10, will fluctuate twice as much as a duration 5 bond.

Finally, short-term and long-term interest rates don't always move lock step. Sometimes short-term rates move up and long-term rates hardly move at all. The "yield curve" doesn't always have the "same curve".

What does all this mean to the bond portion of your portfolio when interest rates rise? Well, short maturity/low duration bonds are generally less affected than long maturity/long duration bonds. So you might want to shorten the maturity and lower the duration of the bonds or mutual funds you hold if you are concerned that interest rates will push bond prices down. It is always best to consult with an advisor knowledgeable in fixed income securities prior to making changes to your portfolio.

Next week this column will continue with other strategies designed to help limit exposure and increase profit potential in a rising interest rate environment. Bonds have fixed principal value and yield if held to maturity. Prices of fixed-income securities may fluctuate due to interest rate changes. Investors may lose money if bonds are sold before maturity. U.S. Treasury bonds and Treasury Bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest.

Gary Case, CFP™, Cornerstone Financial Planning, is a registered representative and investment advisor representative of Lincoln Financial Advisors Corp., 917 2nd St. South, Nampa, 466-1971, offering insurance through Lincoln LFA, Limited Liability Company and other fine companies. He can also be reached by email, at cornerstone_financial@yahoo.com This information is for educational purposes only and should not be construed as legal or tax advice. You may want to consult a tax advisor regarding this information as it relates to your personal circumstances. CRN 0403-1496