Time to Revisit Your Income Oriented Investments

Jason A. McGlone, CFP®, MSFS
920-733-3872

When reviewing the current environment for interest rates, almost all analysts are in agreement that they will rise. Experts seem to be divided as to whether the Federal Reserve will institute the first rate hike this fall or next year. Since there is agreement that rates will rise, perhaps the question that we should be asking is not ***when*** but ***how*?** Everyone is still watching as to when rates will rise, but if they go from zero to a quarter percent, is that a significant event? Are rates eventually headed toward 1%, 2% or 3%, and how long will it take to get there?

Jurrien Timmer, Director of Global Asset Allocation for Fidelity feels, "There are two camps about this. One is the Fed goes early but it goes shallow … the other camp is that the Fed waits much longer than it otherwise would, but then it raises rates much more steeply." His justification is, "I think the economy can handle it, six years past the crisis and with an unemployment rate of 5.2%." He concludes his research report on this subject by admitting, "We'll see: no one really knows."
(Source: Fidelity.com, July 2015)

The bond market is a complex one, but certain facts surrounding it are simple. The bull market for bonds began in September 1981, when the yield on the 10-year Treasury bond peaked at 15.84%. Over the next three decades, bond yields fell to a point where in May of 2013, the 10-year Treasury dipped as low as 1.63%. Recently, it hovered at 2.3%. As bond yields fell, the prices of existing bonds typically went up, up and up.
(Source: Barrons, July 13, 2015)

In 2012, legendary investor Warren Buffett declared that bonds should come with a warning sign! With rates likely to rise in the near to distant future, it makes sense now more than ever for investors to review or revisit their interest rate-sensitive investments. Bonds can be an essential part of a conservative portfolio: they provide income and high grade ones are usually considered more stable than stocks. However, in this environment, investors need to proceed with caution!

How do changes in interest rates affect bond prices?

Typically, bond prices and interest rates move in opposite directions. This means that when interest rates rise, bond prices tend to fall, and conversely, when interest rates decline, bond prices tend to rise.

Here's why:

Suppose you invest $10,000 in a 10-year U.S. Treasury bond with a 3% yield. That interest rate is fixed, even as prevailing interest rates change with economic conditions—especially the rate of inflation. After five years, you decide to sell the bond, but interest rates have risen and similar new bonds are now paying 4%. Obviously, no one wants to pay $10,000 for a bond yielding 3% when a higher-yielding bond costs the same. So the bond's value has decreased.

When interest rates decrease, the reverse happens. If interest rates had fallen and new Treasury bonds with similar maturities were yielding 2%, you could most likely sell your 3% bond for more than your purchase price.

When evaluating your bond related investments an important piece of information is a statistic known as "duration." In finance, the duration of a financial asset that consists of fixed cash flows, like 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 is 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 risk.

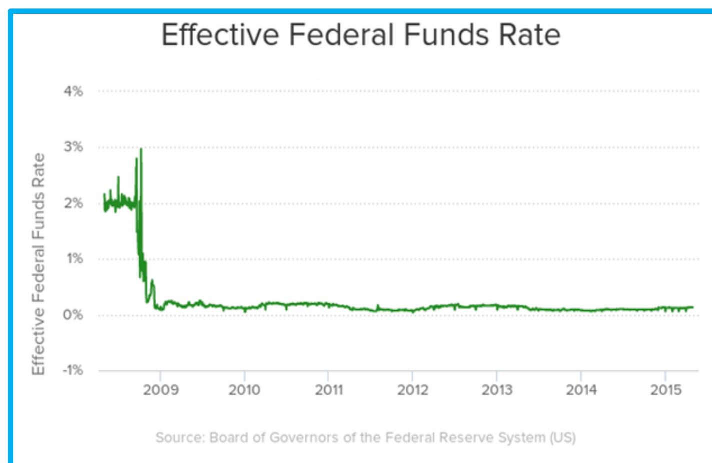
Many investors often put a high percentage of their portfolios in bonds for income or to hopefully generate more stable types of returns. This holds especially true when they are very worried about the economy or other financial issues, or after they have taken a beating in stocks. Unfortunately, in a rising interest rate environment, that logic could present problems.

So 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, in most cases, it's not appropriate to invest only in equities. 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 fixed income investments and cash.

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 some who invested in bonds for capital preservation. Today, all investors now need to reconsider interest rate risk, issuer credit risk and purchasing power risk.



How much value could bonds potentially lose?

As we previously stated, the price of bonds typically moves in the opposite direction of yield. When interest rates rise, the prices of existing bonds go down.

The Change in Interest Rates table shares the expected loss in market value investors can expect based on rising interest rates. The horizontal axis measures the amount of interest rate increase from 1% to 5%.

The vertical axis is the duration of the bond or bond fund. You should read this like a mileage chart. A bond with a duration of 7 years could lose 21% of its market value if interest rates rose by 3.0%. The longer the bonds duration and the greater the increase in interest rates, the greater the loss.

Change in Interest Rates

Duration (Years)	1%	2%	3%	4%	5%
2	-2%	-4%	-6%	-8%	-10%
3	-3%	-6%	-9%	-12%	-15%
4	-4%	-8%	-12%	-16%	-20%
5	-5%	-10%	-15%	-20%	-25%
6	-6%	-12%	-18%	-24%	-30%
7	-7%	-14%	-21%	-28%	-35%
8	-8%	-16%	-24%	-32%	-40%
9	-9%	-18%	-27%	-36%	-45%
10	-10%	-20%	-30%	-40%	-50%

Source: Forbes

4 suggestions to consider using during a period of rising rates:

All investors need to be cautious with their fixed income investments, especially those close to or in their retirement years. Stability and income will always play a role in financial planning. Here are four suggestions that can help:

1. **Maintain complete liquidity for all short-term and near-term needs**. Liquid accounts in today's interest rate environment will probably not keep pace with inflation. Although it is always important to maintain a liquid component in your portfolio, you should think about what major expenses you will incur in the next two years and consider keeping a larger than typical liquid pool of assets.

2. **Choose shorter terms over high yields.** Although shorter term bonds yield less than longer term bonds, they typically lose less value when rates rise.

3. **Review all of your income producing investments.** As advisors, we help our clients review the income producing investments they own. Our primary goal is to match your portfolio to your timelines and personal financial situation.

4. **Monitor your portfolio regularly**. Interest rates can move quickly or slowly. In either case we can help monitor your portfolio and suggest adjustments as needed.

Conclusion:

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, like investment grade corporate bonds and treasuries. Just because they have the same level of duration, this 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. We are constantly overseeing the investments we recommend to clients and take this into consideration. 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 friends and associates.

P.S. If you have any questions, don't procrastinate! We are always available to review your investment portfolio to make sure you understand the advantages and disadvantages of all of your fixed income investments. Remember the old saying, "If it ain't broke, don't fix it." However, how would you know if it is not broken unless you had a qualified professional review it!

As your financial professional, we strive to regularly watch and review all the fixed income recommendations we offer.

While no financial professional can guarantee any type of specific return, we attempt to continually oversee your situation and our recommendations.

We pride ourselves in monitoring the interest rate environment and offering all clients a financial review when necessary.

Help us grow in 2015!

This year, one of our goals is to offer our services to several other people just like you!

Many of our best relationships have come from introductions from our clients. Do you know someone who could benefit from our services?

We would be honored if you would:

- ✓ Add a name to our mailing list,
- ✓ Bring a guest to a workshop,
- ✓ Have someone come in for a complimentary financial checkup.

Please call Jason at Kerntke Otto McGlone, (920) 733-3872and we would be happy to assist you.

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You should discuss any tax or legal matters with the appropriate professional.

Sources: Fidelity 7/2015; Barron's 7/2015; Forbes 6/2013 *© Academy of Preferred Financial Advisors, 2015*