The Risks of Rising Interest Rates – *Know What You Own*

Doug Drabik – Senior Retail Strategist | **Benjamin Streed** – Retail Strategist
Douglas.Drabik@RaymondJames.com | Ben.Streed@raymondjames.com

Key Discussion Points

- Changing interest rates and the resulting bond prices are an uncontrollable reality. The math is basic. **Rising interest rates will negatively affect security prices regardless of whether that security is held within a portfolio of individual bonds, a managed fund or other packaged investment.**
- Headline noise suggests that the risk of rising interest rates should inhibit purchasing fixed income securities. Although rising interest rates may eliminate price appreciation, most portfolios utilize fixed income securities as a means of safety, to protect principal dollars when held to maturity.
- As with any asset class, attempting to time the market is a risky practice. Beyond the decision of *when* to buy bonds, perhaps a more important consideration is *how* to buy bonds to optimize portfolio performance in dynamic interest rate environments.
- **A strategically constructed portfolio, barring default, can produce intended results despite volatile market fluctuations and unpredictable economic changes.**
- Duration on securities with embedded options (i.e. a call feature) can extend significantly if rising interest rates dictate pricing to maturity versus pricing to the call.
- Duration for a single security cannot be compared to the duration for a pool or portfolio of securities.
- An investor can control 100% of individually held securities, and 0% of assets held in managed funds.
- Portfolio strategies need to match investor needs.
- **A *Shock Analysis* provides useful information in identifying interest rate risk inherent in portfolios.**

Interest Rates Up?

The ability to predict interest rates is, at best, speculative. To put it politely, no one is very good at it, but lately, industry experts and media pundits collectively seem to agree that there is an impending rise in interest rates on the horizon. The market sentiment for rising interest rates stems from the current historic low interest rate environment paired with the implication that rates have only one direction to go. Given this possibility, the questions that follow include: “when will interest rise?”, “by how much?” and “how could this affect an investment portfolio?”

Foreign policies, currencies and political turmoil contribute to a global market that continually interacts with the U.S. domestic market. In addition, headline news muddles equity and bond market direction and sentiment. These numerous variables make it impossible to anticipate or predict timing of interest rate moves. Still, with interest rates at historic lows, having fallen in general for 31+ years, the communal prediction for rising interest rates is not surprising. However, the dispute over “when” interest rates will rise persists.

Know What You Own

Most dollars that are allocated to fixed income assets represent the conservative assets associated with the overall portfolio. Typically, the percentages of assets dedicated to fixed income securities increases as investors age and accumulate wealth. The focus shifts from asset growth and accumulation to wealth preservation. An appropriately constructed portfolio should be indifferent to volatile price swings associated with fast moving interest rates. With individual bonds, this price adjustment is reflected as an unrealized or paper change only. If an investor holds onto the bond, it will continue to provide cash flows as intended at the time of purchase. Barring a call at the issuer’s option or an issuer default, the individual bonds will return interest via its coupon payments and return the face value of the security upon maturity. A sale of a bond *prior* to maturity may result in the investor *realizing* a gain or loss.

It is difficult to compare individual bonds to packaged product. With individual bonds, an investor maintains 100% control of a decision to buy, sell or hold an investment. An individual investor forfeits this control with managed or packaged products. This means that during periods of rising interest rates, investors holding packaged products may experience declines in income, value or both due to the actions of the fund manager and outside the control of the investor.

Package product can appeal to an investor whose percentage of assets dedicated to fixed income is too small to diversify appropriately with individual bonds. Funds also provide some protection against default as any such event is mitigated across all holders. However, rising interest rate environments increase the possibility that bonds are sold and/or bonds within the fund lose market value. These changes can manifest in a lowered net asset value which means a potential for lost principal dollars to an investor. Additionally, there is also a possibility of embedded capital gains when investments held in a fund are sold at a profit. This could even create a taxable situation for an investor.

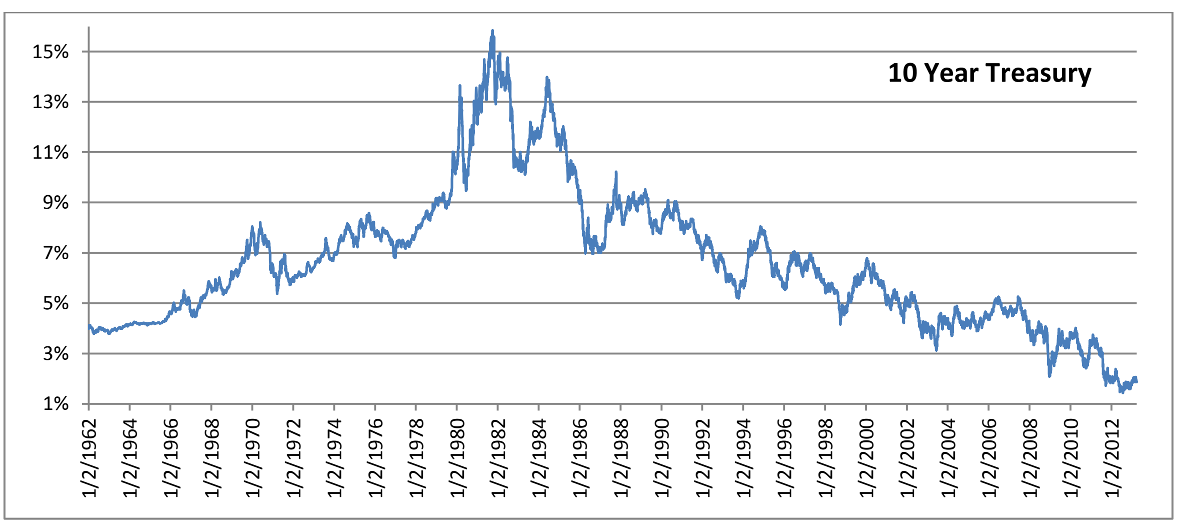
Customized Portfolios

One of the most important advantages of individually held bonds is the ability to customize a portfolio. No two investors have the exact same household structure or cash flow needs. In addition, timing, desires and obligations vary. A customized portfolio allows for individual risk assessment resulting in tailored portfolio alignment. These customized differences are exhibited with credit choices, maturity, diversification, coupon and blended portfolio structure. Barring any unforeseen default issues, when a portfolio is aligned to meet an investor's needs and goals, it will produce the desired results regardless of changes in interest rates. This advantage is a function of an individual's ability to control assets and actions on their own.

Potential rising interest rates are rightfully creating uneasiness within current investment accounts. Raymond James provides a deep pool of expert traders, strategists, and technical resources to protect client fixed income portfolio benefits. These resources include: Advisor Access tools with portfolio builders and evaluation reports as well as Bondwave detail asset statistics and prognosis reports. An experienced team is available to assist advisors in this regard.

Duration - An Important Tool for Interest Rate Hike Concerns

Duration is a risk measurement. Duration measures a bond's price movement given a change in interest rates. Since price and yield maintain inverse relationships (i.e. as rates rise, prices fall), it is essential now more than ever, that an investor understands what they own. As the graph below depicts, interest rates in general have fallen since September, 1981. During this period, bonds realized the benefits of coupon income and also capital appreciation (rates fall, prices rise). Current headlines suggest that now may not be the best time to purchase bonds citing the possibility that interest rates have bottomed out. Therefore, if interest rates rise, price depreciation (versus appreciation) may occur. Timing the market is fool's play. Rather than deciding *when* to buy bonds, the more important decision is *how* to buy bonds in order to optimize portfolio performance in dynamic interest rate environments.



Knowing what you own in a potentially rising interest rate environment becomes critical. Knowing how investment holdings will perform and isolating the risks and/or rewards of these changes is important. It is highly recommended that you request a Portfolio Shock Analysis for each investor to better understand where each investor's risk lies. Duration turns out to be a key measurement in identifying the market price risk associated within portfolio holdings.

A duration of 3 means that a 1% (100 basis point) change in interest rates will result in an approximate 3% change in the market value of a bond. Remembering the inverse relationship between interest rates and yields, a 1% rise in interest rates means approximately a 3% decline in market value. This math should not scare an investor. As interest rates rise, existing securities must be adjusted to stay competitive in the new rate environment. Since a fixed coupon is static, the only way to adjust the value of a fixed coupon security is to change the price.

Duration is easier understood in relationship to an individual security. With multiple securities, a duration of 3 could for example, be a blend of five securities with a duration of 3 or five securities with durations of 7, 4, 2, 1 and 1. Each of these portfolios has very different profiles regardless of the fact that they both carry a blended duration of 3. The second portfolio's duration risk clearly could change quickly should any of the securities be sold or swapped. Furthermore, investors who cannot control whether the securities are held-to-maturity or swapped in-and-out are proportionately at more risk of being affected by changing interest rates. An investor in a managed fund for example, is at the mercy of the manager's decisions. Bonds that are sold within the fund realize the market variances that an individual bond holder would not if their bond was held-to-maturity.

Plan of Action

Fixed income as an asset class can be part of a well balanced portfolio. The positioning of the fixed income component is the key to maintaining the performance expectations. Fortunately, fixed income portfolio strategy is not reliant on the impossible interest rate prediction game. Portfolios are structured to optimize return and perform suitably irrespective of interest rate moves. A proficiently constructed portfolio provides the desired returns, cash flows and performance intended.

For individual investors, there are several broad strategies structured to address interest rate risk. A laddered portfolio is a portfolio that spreads maturities in a balanced format over a given length of time. For example, the portfolio may align 20% of total funds to mature in years 1, 2, 3, 4 and 5. Since 20% of the portfolio matures every year, 20% of the portfolio is reinvested under new interest rates every year. A laddered structure will therefore capture highs and lows and mitigate interest rate moves while avoiding interest rate "guessing."

A barbell strategy can also minimize exposure to rising interest rates. Certain investors require a certain amount of cash flow from their portfolio. Extending out on the curve may be necessary in order to produce needed cash flow. Investing as little as possible with longer, higher yielding securities generates required cash flow while the balance of portfolio funds are invested in shorter duration securities. The shorter maturities lower the overall duration and allow an investor to partially capture interest rate changes via quicker principal return and reinvestment.

This current economic period dictates the usefulness and perhaps need to "shock" your portfolio. A *Shock Analysis* is designed to identify the duration, and thus the pricing/value exposure that a portfolio has to rising interest rates. It will express the potential dollar value change for a given interest rate move and allow an investor to anticipate any risk adjustments required to stay within the framework of your individual portfolio needs and goals.

A fixed income allocation comprised of individual bonds can be designed to protect principal and support desired return with a known risk profile and principal preservation unlike any other asset class.

Investing involves risk and you may incur a profit or a loss. The value of fixed income securities fluctuates and investors may receive more or less than their original investments if sold prior to maturity. Bonds are subject to price change and availability. Investments in debt securities involve a variety of risks, including credit risk, interest rate risk, and liquidity risk. Investments in debt securities rated below investment grade (commonly referred to as "junk bonds") may be subject to greater levels of credit and liquidity risk than investments in investment grade securities. Investors who own fixed income securities should be aware of the relationship between interest rates and the price of those securities. As a general rule, the price of a bond moves inversely to changes in interest rates. Diversification does not ensure a profit or protect against a loss. Raymond James & Associates, Inc. member New York Stock Exchange/SIPC and Raymond James Financial Services, Inc. member FINRA/SIPC.