Scarsdale Investment Group
The Unbeaten Path to Secure Investment Growth

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But, What If Interest Rates Rise?

Like taxes, we are told that rising interest rates are inevitable. We know that at some time in the future, interest rates will rise, but no one really knows when this might happen. That does not stop the media from making dire predictions about the losses that will be inflicted on bondholders everywhere in the form of lower market values.

Given these dire predictions, why do investors continue to buy bonds? The twentieth century poet and novelist, James Oppenheimer said: "The foolish man seeks happiness in the distance; the wise grows it under his feet." That is what bond buyers do. They lend money to governments and corporations in return for current interest income. Insurance companies buy bonds to support their guaranteed rates on insurance products. Banks use interest income to pay the interest on their depositors' bank accounts.

How to Plan

Individuals like you and us count on interest income to create a stream of predictable cash flow, and to reinvest in other bonds or investments for current and future growth. We don't hope the flowers will bloom in the spring – we plan for retirement and financial independence by investing in bonds that pay a predictable cash flow now and in the future.

It is important to manage our expectations. We can wish and want and hope for higher interest rates, but ultimately we have to look at the current investment environment that frames our possible choices. Part of our retirement planning may be to work longer, save more, and spend less. It is useful to have a viable plan.

Alternative Investments and Your Risk Tolerance

What does it mean to have a tolerance for risk? Does it mean that you have a tolerance for the fluctuation of the value of your investments? Or does that mean that you are willing and able to sustain substantial real losses if the values of your investments were to plummet in value and you may cash out of the investment only at a big loss? Walter Updegrave, a writer at Money magazine, describes it this way:

> For starters, think seriously about how much you could watch your savings drop before you panic. From the market's 2007 peak to the 2009 trough, stock value plunged more

> than 50%, while bonds rose roughly 6%. A portfolio of 90% stocks and 10% bonds fell 45%; a fifty-fifty mix was down about 22%. If you think 20% or so is the most heat you could stand, a 50% stock stake is probably close to your upper limit, even though that's far less than what's often suggested for someone your age. (Age 31).[i]

This view of risk taking is short run, only taking into account what you can tolerate in the moment. The fear is that if the market were to decline substantially, you would sell out your position in a panic, locking in your losses. It is our nature to think that that gains that have accrued in our investments will be there forever so we do not have to close our positions to secure these gains. We view losses as only temporary and believe that if we hold them long enough, they will eventually recover. We do not take into account that we could make money elsewhere in the meantime.

Perhaps it is also that you may have run out of time. If you are near retirement, you have to look forward to how you are going to fund the rest of your life. It is suggested that those over 65 dial back their risk. If you are over 65 and you deplete your nest egg, it may never recover in time to help you. However, the problem may be that although you may know that the risks are great, you may think that you can handle them until something earth shattering happens. As the British author W. Somerset Maugham states: You can do anything in this world if you are prepared to take the consequences."

Betting on stocks is risky because even if your stock position has gains, they may turn into losses before you close your position. Peter Stockholder was sitting on gains in 2000, but had to wait 13 years for the Standard & Poor's 500-stock index to surpass the record high in 2007. Such an extended period of low returns is called a secular bear market. During this secular bear market, returns have been about 1% according to Jurrien Timmer, manager of Fidelity Global Strategies Fund, while the secular bull markets in the 1980s and 1990s averaged annual returns of 18%.[ii]

Anticipation and desire for those high returns are what spurs investors to put money into the stock market. However, even a great stock like Apple has seen a 33 percent share drop from its record high on September 21, 2012.[iii] Mr. Easterling of Crestmont Research says that the recent rise in the stock market may mean that the bear is slumbering, and that it may reassert itself should inflation rise.[iv] It may mean we are still in choppy seas – still in a secular bear market.

Diversification may not be effective to prevent substantial declines. Investors are often told by their financial advisors to diversify because portfolio diversity will protect them in hard times. Jason Zweig says: "Unfortunately, markets forget all about theory during a financial panic."[v] In the panic of 2008 - 2009, all investments crashed together. He points out those past correlations don't matter. In the 1980's and the 1990's stocks and bonds moved together, says Zweig, but in the 2008-2009 financial crisis Treasury bonds were the only asset that appreciated.

Market Timing

One issue that arises from investing in fast moving markets is that it can engender two extreme responses. One response is to stick your head in the sand and not open or look at your brokerage statements. When you get e-statements, they don't even clog the mailbox. You have to go and look for them, so it is easy to forget about them. Then there is the reverse: constantly checking the Internet to see how your stocks are doing. This interrupts your waking hours when you could be using your time more productively.

A second issue is that while you are investing in the possibility of stock gains that may or may not be realized, you forgo the actual receipt of interest income that could have compounded semi-annually over the same period. This is a lost opportunity that should be put in the balance of any investment decision.

<u>What If Interest Rates Do Rise?</u>

Faced with the current context of interest rates that are historically low, we are told that the Federal Reserve is pushing investors into riskier assets. Investors, who have sat on the sidelines waiting for interest rates to rise, realize it may not happen soon, and they have to play catch up.

We made a simple call. We decided that 3.5 percent was more attractive than 1 percent or possible losses, which is how we decided to purchase longer term bonds. What will happen in the future? No one knows. However, at some point we do know that interest rates will rise. In the meantime, the maturities of our bonds are getting shorter and we have secured a good cash flow.

The media is anticipating an interest rate rise, and is currently warning investors away from making any bond investments. In addition, the media is advising that bonds are losing their value and that you had better sell fast. How do you invest in the face of such advice? What are some possible scenarios?

- Those invested in Exchange Traded Funds (ETFs) may exit as quickly as they can. If that happens, then the ETFs will function like the closed end funds that they are – they may trade at a discount to the fair market value of their assets.
- The ETFs and the mutual funds may have to start selling their best bonds because those are the ones that will trade at the best prices. This happened in 2008 at the beginning of the financial crisis. This will present a buying opportunity for those with cash.
- The media will report that bond prices are falling. They will not tell you that some bonds are rising in value as others are falling, which is likely if the yield curve changes shape. The yield curve is described as "a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates."[vi] The media usually quotes the Treasury yield curve, but it does not usually tell you that the yield curves of corporate bonds and municipal bonds do not necessarily track it.
- Media reports may encourage you to invest in floating rate bonds and notes and funds that hold these investments. On the face of it, this sounds like good advice if you expect

interest rates to rise. Unfortunately, those in the know will be the first to exit these investments when interest rates are rising. They contain low quality loans that are kept afloat by low interest rates and the ease of rolling over the loans. If interest rates start rising and roll overs become more difficult, the number of load defaults rise also. Ditto for high yielding, long-term asset-backed securities and corporate bonds that are dependent on low interest rates to keep them solvent.

- The media will tell you that rising interest rates means that you will lose money. It does not tell you that if you are a bond holder with a bond ladder that this is your upside case. You can take the interest earned and the cash retuned when a bond comes due, and reinvest it at higher interest rates instead of lower interest rates. Overall that would give you a net higher cash flow on your bond portfolio if you do not have to sell and can wait until the bonds mature at face value (par).

The bond ladder is the strategy that enables the individual bond buyer to survive and thrive when interest rates are rising. A bond ladder consists of bonds that mature in a ladder of multiple years. Some bonds may come due this year, some next, some five years out, and longer. When bonds come due, they return the principal investment, plus interest. If you can then invest the proceeds at higher interest rates than are currently available, this is your upside case.

Where Can I Buy the Piñata with the Cash Inside?

There are no perfect investments that will always give you gains. Bonds may give you capital gains, but they also provide cash flow from regular interest payments. Individual bonds keep producing seeds for reinvestment and consumption, and require little to no maintenance if your strategy is to buy and hold high quality bonds. They come due and give you your money back eventually. In this way, you can have peace of mind.

As financial planner Al Wroblewski states: “How clients’ portfolios perform compared with a benchmark is irrelevant. If the S&P 500 Index goes down 30% and their portfolio goes down 28%, they’ve beaten the benchmark but may be in serious trouble in terms of their goals.”[vii] Individuals are not institutions, with its practically infinite time horizon, he further notes. We have to realistically assess what can be accomplished within the financial context of our finite lives, and the financial context of the world around us.

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[i] Walter Updegrave. “What’s my risk tolerance? I’m 31 and 90% in stocks, but I’m not willing to take a 50% hit.” *Money, March 2013 p. 34.*

[ii] Tom Lauricella, “Is Bull Sprint becoming a Marathon?” *The Wall Street Journal*, February 11, 2013, C1

[iii] Peter Burrows. “Apple Margin Squeeze Has No Easy Fix Amid 33% Share Drop,” *Bloomberg”* February 11, 2013.

[iv] Lauricella, C2

[v] Jason Zweig. "A Bucket List for Better Diversification," *The Wall Street Journal,"* February 9-10, 2013.
[vi] Investopedia.com. http://www.investopedia.com/terms/y/yieldcurve.asp#axzz2LHCx3RqO
[vii] Nancy Opiela. "Overcoming Decision Fatigue," *CFA Institute Magazine,* Nov/Dec 2012, p. 37.