Positioning your portfolio in a rising interest rate environment

The fixed income markets experienced a significant increase in interest rates in the fourth quarter of 2016. On October 1st, the ten-year U.S. Treasury Note stood at 1.60%. The yield had increased to 2.59% on December 16th and currently sits at 2.33% as of this writing. Additionally, in December the Federal Reserve raised its target rate by 25 bps or ¼ of 1%. The Fed Funds target range is now set to .50% to .75%. While investors saw healthy returns in equity markets, many had losses in the fixed income portion of their portfolios as bond prices and yields have an inverse relationship. When interest rates rise, bond prices fall. The upward trend in rates over the last quarter and more rate hikes expected by the Fed has led investors to ask the question, how do I protect my portfolio in a rising interest rate environment?

There are several strategies which investors can employ to better positon themselves when interest rates rise such as diversifying fixed income sectors, shortening bond durations, purchasing bonds with floating rates, bond ladders and overweighting/underweighting certain equity industries. With regard to fixed income sectors, Treasury securities have greater sensitivity to interest rate increases than corporate or municipal bonds. Corporate bonds with lower credit quality are more resilient than Treasuries as rates rise because the total return is determined by both price appreciation and income paid by the company that issues the debt. When the economy improves, consumers have more disposable income to spend on goods and services, thereby increasing corporate profits and improving a company's balance sheet and ability to pay interest on outstanding debt. Similarly, municipalities with lower credit quality may experience improved cash flow from higher taxes due to rising consumer wages. Investors can review their fixed income allocation and diversify among various types of lower credit bonds (high yield bonds) to lower volatility. Investors should be aware that while high yield bonds carry lower interest rate risk, they carry higher credit risk and issuers may still default on outstanding debt. When making the decision to purchase municipal bonds, investors should also consider account type and tax bracket.

In addition to the fixed income sector of the bond, one of the other key determinants of interest rate sensitivity is the duration of bonds held inside of the portfolio. The shorter the duration of the bonds in the portfolio, the less sensitive the portfolio will be to rising interest rates. Investors can shorten the duration of the bonds in their portfolios to reduce price volatility by avoiding longer maturity bonds and bond funds in favor of short or intermediate maturity bonds and bond funds.

Investors can also purchase floating rate securities which offer a measure of protection in a rising rate environment. Floating rate securities are debt instruments usually with maturities of less than three months whose interest rates reset to the current market rates as the debt rolls over to another term. Another option available to investors seeking a defensive strategy is Treasury Inflation Protected Securities (TIPS). TIPS offer a low fixed interest rate coupon and a variable adjustment to principal based on the Consumer Protection Index (CPI). While TIPS do not completely remove interest rate risk, they can add a measure of protection for investors seeking the safety of Treasury securities. Inflation expectations usually move in tandem with interest rates over the intermediate term.

One other common strategy that can be used in a rising rate environment is creating a bond ladder. With a bond ladder, investors purchase several bond issues each with different maturity dates. When each bond comes due, the proceeds can then be used to purchase another bond at higher interest rates.

The most conservative option for investors concerned about rising rates would be to sell a portion of their bonds and hold the proceeds in cash or ultra-short maturity CD's and bonds (3-6 month maturities). While this strategy can protect against price depreciation in bonds, over time investors may earn very little on the funds should the Federal Reserve raise rates more slowly than expected.

Investors with a moderate risk tolerance may also seek to diversify a small portion of their fixed income portfolio with global bonds. The performance of global bonds may be less correlated to those bonds in the U.S. fixed income market as central banks in foreign countries may have policies that are meant to lower interest rates, thereby offering shareholders opportunity for capital appreciation. We would caution though that countries with easing monetary policies may still face political, economic or exchange rate headwinds.

While it is important to review the composition of the fixed income portion of your portfolio, it is also beneficial to examine the equities you own. Some equity sectors perform better than others in a rising interest rate environment. Equity sectors that typically outperform in a rising rate market are the consumer cyclical, financials and technology sectors. Stocks in the consumer cyclical sector include retailers, restaurants, and homebuilders. Financial stocks would include banks, insurance companies and other companies with diversified financial businesses. Technology stocks include but are not limited to internet, hardware, software and semiconductor companies. Stocks in sectors which investors had previously considered bond equivalents in a low interest rate environment such as utilities and Real Estate Investment Trusts (REITS) may underperform. In a higher interest rate environment there is less incentive to purchase stocks in these sectors as investors can purchase similar yielding fixed income investments with less risk. Similarly, dividend paying funds and ETFs (Exchange Traded Funds) may be less attractive if fixed income investments offer a competitive yield.

We anticipate the potential for additional modest increases in the Federal Funds interest rate in the coming year, reversing a long-term trend of the near-zero policy. While this move will generate headlines, investors should avoid temptation to get caught up in any short-term volatility and focus instead on long-term fundamentals such as economic growth. A calculated allocation to fixed income, equities and real estate using some or all of the above mentioned strategies could offer compelling benefits for diversified, long-term investors.

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