BUILDING BLOCKS FOR RETIREMENT

Risk Tolerance

How Rising Interest Rates Can Impact Investors

Like everything else in the economy, interest rates tend to move in cycles. So after several years of very low interest rates, investors shouldn't be surprised to see a period of rising interest rates.

Real Life Impacts

The real-life impacts of rising interest rates on consumers are significant. While the opportunity to earn higher returns on money held in savings accounts can be beneficial, an uptick in interest rates makes credit more expensive. Consumers may find that it costs more to borrow money for home and car purchases and see the interest charges on their credit card bills go up. Rising rates on adjustable rate mortgages can mean that homeowners must allocate more of their income toward paying their mortgages and homeowners with equity credit lines will pay higher rates of interest. This increase in expenses means that homeowners may have to reduce the amount of money they put into retirement or other investment accounts.

Impact on Fixed-Income Investments

Investors who pay face value for a bond and hold it to maturity expect to have their investment returned in full. In fact, with U.S. Treasuries, there is virtually no risk of default because they are backed by the full faith and credit of the U.S. government.

However, bond prices typically fall when interest rates rise, and a bond sold before maturity may be worth less than its face value. Investors who choose to own bonds to reduce the volatility in their portfolios may need to revisit their fixed-income exposure when interest rates start to rise.
By reviewing the types of bonds in their portfolios and examining their durations, investors can assess their portfolio's vulnerability in a rising interest rate environment. Duration measures a bond's sensitivity to interest rate movements and can be useful in helping investors compare bonds with different coupon rates and maturities. Essentially, the higher a bond's duration, the greater the bond's sensitivity to rate changes.

Rising interest rates have the greatest impact on long-term bonds. The fact that their maturities are so far into the future makes them less attractive to investors because a longer time increases the probability that rates will rise while the bond is outstanding.

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Investors may gain some protection from rising interest rates by selling bonds in their portfolios that won't mature for many years and replacing them with bonds that have shorter maturities. The trade-off is that short-term bonds generally pay interest at lower rates than long-term bonds.

A financial professional can help you assess your bond portfolio and the current economic risks to best move forward.

The Risks to Stocks

With more of their income going to interest payments, consumers may reduce their discretionary spending. This, in turn, can reduce corporate revenues and profits, which then reduces the attractiveness of many stocks, generally causing stock prices to drop. Higher interest rates also make it more expensive for companies to borrow money to finance their operations and expansion plans, suppressing their future earnings potential -- and their stock prices.

Note, however, that certain sectors of the stock market tend to benefit from rising rates. For example, a bank's stock price may rise when the spread between the interest it pays depositors and the interest it receives from borrowers widens, increasing the bank's profitability.

Asset Allocation and the Long-Term View

Different asset classes do well in different market conditions. Owning a mix of stocks, bonds, and cash investments may help investors balance risk and return and may give investments a better chance to grow, whatever interest rates are and market conditions are like. However, asset allocation cannot ensure a profit or protect against a loss.

A financial professional can offer valuable insights on how best to manage an investment portfolio during periods when interest rates are changing.

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