Preparing for Rising Interest Rates

Even a modest increase could have a major impact on your financial life.
Here's how you can help offset the risks, while taking advantage of opportunities.

With the economic recovery taking hold, many market watchers foresee an inevitable, steady rise in interest rates. Three years ago, in an effort to stimulate economic activity, the Federal Reserve began purchasing long-dated government bonds and mortgage-related bonds, thereby forcing down long-term interest rates – a program known as quantitative easing (QE). The anticipation of the Fed beginning to taper its bond-buying program has already resulted in a broad-based rise in yields and decline in bond prices.

But the reality is that the Federal Reserve is likely to change policy very slowly and only as they see clear evidence of sustained, solid growth. Ethan Harris, co-head of global economics for BofA Merrill Lynch Global Research, believes that job growth would have to improve from its recent monthly pace of around 170,000 for the Federal Reserve to curtail its purchases. With fiscal austerity hitting the economy, including both tax increases and spending cuts, the Fed might not announce a change in the pace of its purchases until the end of this year. That means that the recent surge in bond yields might not be sustained.

The Global Research Rates Strategy Team sees the yield on the 10-year U.S. Treasury note, which stood at 2.60% on June 24th, to rise further in 2014, although there may be some decreases along the way. Their target for the end of 2014 is 4.00%. But even small increases in yield could have an effect on your investment portfolio, as well as other assets such as a mortgage. Additionally, inflation – what Marty Mauro, fixed income strategist for BofA Merrill Lynch Global Research, calls the "great enemy of bonds" – could also eventually become a concern. Here are steps you can take now to prepare for the potential impact of rising interest rates.

- **Reallocate.** Based on your specific risk profile, you can potentially reduce some of your bond allocations as part of a short-term (12- to 18-months) tactical strategy in favor of equities. You can then supplement the resulting reduction in income, or possibly even increase your income, by looking for dividend growth stocks – companies with a solid track record of regularly hiking their dividends. It's critical to work closely with your advisor, who can suggest an allocation strategy based on your investment profile, risk tolerance, liquidity needs and long and short-term goals.

- **Shift.** The longer a bond's duration, the less attractive it will be when interest rates rise. That's because it will pay less income than newer bonds pegged to the higher rates, and do so over a longer period of time than shorter-duration bonds. Therefore, consider shifting the durations of the bonds held in your portfolio—buying those with shorter-term maturities and selectively selling those with terms longer than ten years.

  One option is to create a bond ladder – purchasing an assortment of bonds that mature at different intervals. As each bond matures, proceeds are reinvested in the longest-duration security. By reinvesting the proceeds at the current interest rate, you build a portfolio that has an increasing yield as rates rise – leading to the potential for higher total returns. Mauro notes that this strategy can potentially be beneficial for retirees: "You can take advantage of the higher yields that you generally get with longer maturities, without taking an undue amount of interest rate risk."

- **Diversify.** Shifting your long-term bond allocations may result in reduced income. To offset that, you can look to certain other types of fixed income. For example,

high-yield corporate bonds can be attractive in an environment where the economy is in a solid recovery, since that should make it more likely for companies to meet their debt obligations. (To learn more about the economic and geopolitical shifts happening around the globe, see our **Transforming World program**.)

Also consider professionally-managed bond mutual funds, which enable you to invest in several different bonds and debt securities with one selection, or securities with exposure to interest rates, such as Treasury Inflation Protected Securities (TIPS). TIPS is a type of government bond that provides protection against inflation, along with twice-yearly interest payments. Inflation is a concern for bondholders because rising prices would threaten the purchasing power of the income that a bond provides. With TIPS, the principal value rises with the Consumer Price Index (CPI) and your interest payments fluctuate accordingly. When a TIPS matures, you are paid the adjusted principal or the original principal, whichever is greater.

- **Refinance.** Finally, while lower rates have made borrowing more affordable in recent years, mortgage rates will likely rise as interest rates do. If you're looking to refinance, buy a second home, or contribute to a child's home purchase, now may be the time to explore your options. This could also apply for other purchases that may require loans – such as a car, home improvements, or even business equipment. (To learn more about the resurgence in the housing market, watch our video, **Housing's Strength**.)

Merrill Lynch analysts agree that the next rise in interest rates is likely to be gradual. While you may have some time to carefully consider all the ways you can adapt now to offset the risk of rising rates, time is of the essence – especially as you review all the ways a rate hike may influence your goals today and down the road. As always, it's important to work with your advisor to identify the right strategies for you.

To keep abreast of interest rates and other factors that could affect your financial life, follow **Merrill Lynch on Twitter**. ■

For more information about the impact of rising interest rates on investment portfolios, please see our recent whitepaper ***"Fixed Income Investing for a Rising Rate Environment."***

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Equity securities are subject to stock market fluctuations that occur in response to economic and business developments.

Dividend payments are not guaranteed. The amount of a dividend payment, if any, can vary over time.

TIPS pay interest at a fixed rate. Because the rate is applied to the adjusted principal, interest payments can vary from one period to the next. If inflation occurs, the interest payment increases. If deflation occurs, the interest payment decreases.

Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments, and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

Income from investing in municipal bonds is generally exempt from federal and state taxes for residents of the issuing state. While the interest income is tax exempt, any capital gains distributed are taxable to the investor. Income for some investors may be subject to the federal alternative minimum tax (AMT).

Investments in high-yield bonds (sometimes referred to as “junk bonds”) offer the potential for high current income and attractive total return, but involves certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer’s ability to make principal and interest payments.

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