Merrill Lynch Wealth Management

Preparing for Rising Rates

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Please see important information at the end of the program

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MS. BARTELS: I'm Mary Ann Bartels, with Merrill Lynch Wealth Management. Today we'd like to discuss why we think the economy is entering a period of rising interest rates, and the potential impact this can have on investors' fixed income portfolios.

[CHART]
The Long Decline in Bond Yields
Yield on 10-Year U.S. Treasuries
(1981 thru 05/31/2013)
Source: BofA Merrill Lynch Global Research, Bloomberg

For the past 30 years, yields have been in a steady decline. With interest rates today still near historic lows, we believe they could start to rise gradually. And this could have important implications for your portfolio.

Joining me to discuss what investors can do now to stay ahead of the curve is Marty Mauro, our fixed income strategist with BofA Merrill Lynch Global Research.

MS. BARTELS: Marty, Let's start with your outlook for the path of interest rates could take from here.

MR. MAURO: Well I think the first thing to say is that we're probably seeing the bottom in interest rates. Now we're going to move higher, I think, irregularly, and gradually. The thing to recognize is that the big enemy of interest rates, the thing that would give us much higher interest rates, inflation, really isn't a factor now. So we'll see a gradual rise over time.

[LOWER 3RD]
A rise in interest rates could call for a change in one's investment approach

And it does call for people to change their investment approach a bit. Many people have never seen a bear market in bonds. We've had a 31-year decline in rates, as you
mentioned. So you need to approach that kind of market a bit differently.

MS. BARTELS: With that outlook for interest rates, what should our clients consider in their fixed income portfolios and other finances?

MR. MAURO: Well, the thing to recognize about rising rates is that the value of an individual bond would decline.

[LOWER 3RD]
As interest rates rise, the value of an individual bond declines

You have a bond that's paying say, 3%, and now market rates are 4%. You're going to have to lower the price of your bond to get somebody to want to buy it.

So there are various things that people can do.

[TEXT GRAPHIC]
To Protect From Rising Rates:
- Avoid bonds with longer maturities
- Try “laddering” your bond portfolio

One is to avoid very long-term maturities because that decline in price is greater for longer maturities than it is for shorter maturities. Another is portfolio laddering. Buy a mixture of different maturities, a one-year, three-year, five-year, one-year, five-year, ten-year, and as each portion matures, you reinvest in that longer maturity. This way you're reinvesting at that higher yield.

MS. BARTELS: And the concept of laddering is if rates are rising, you're getting that higher interest rate or coupon. Is that correct?

MR. MAURO: Yes, that's right. And it's something equity investors may be familiar with, dollar cost averaging. It's a similar kind of concept, that you're taking advantage of the lower prices to reinvest at those lower prices, reinvest at higher yields.

[TEXT GRAPHIC]
To Protect From Rising Rates:
- Try “laddering” your bond portfolio
- Consider a “barbell” approach

Another related strategy to laddering is barbell. Similar concept: you buy something very short, and you buy something very long. Combine them in different percentages depending upon your risk tolerance, and where yields are. And then you have something that comes due in a short period that can be reinvested at the new market rates.

Another thing you could look at, and it's very rare that you would hear this from a bond guy, but you could look at the stock market.
Yields on 10-Year Treasury Bonds are close to the dividend yield of the S&P 500

And the yields on the Treasury securities are actually now very close to the dividend yield on the S&P 500. And it's very rare that that happens. You have to go back to the 1950s for that to have happened for a sustained period.

So there are areas of the stock market that Savita Subramanian, who's our equity strategist, actually likes better; companies where she thinks that dividends will be rising, rather than the higher yielding companies. So that's a place to look to.

MS. BARTELS: A rise in interest rates has different implication for investors depending on their particular stage of life. What are you recommending to our clients depending on where they are in terms of their stage of life?

MR. MAURO: Well I think you approach things differently at different stages in life. So let's just say a young couple who has young kids, they're saving maybe for college. Maybe they're saving for their own retirement.

Younger investors may choose longer maturity bonds due to their longer investment time horizon

You could buy, say a 20-year or a 30-year bond, and you would know what your value will be at maturity. There'll be some fluctuation along the way, but as long as the bond doesn't default, you know what you'll be getting. You know what your income payments will be along the way.

If you're retired, maybe you don't think that far into the future. And so then you have to be a little bit more careful about taking very long maturity exposure because the decline in the price of a bond will be greater for a bond with a longer maturity than a bond with a shorter maturity.

Retirees may consider “portfolio ladder” strategies to gain access to capital on a regular basis

So retired people might think about things like portfolio laddering, combining different maturities. This way you have money coming due on a regular basis, and you can reinvest at those higher market yields.

MR. MAURO: So Mary Ann, given what we're expecting for interest rates and what we expect for the markets in general, what steps or strategies are you recommending for our clients?

MS. BARTELS: First of all, what I think our clients really need to understand is fixed
income is part of an overall asset allocation decision. You cannot remove the fixed income component. But we do think some volatility is now coming into play as the Fed is starting to talk about quantitative easing, in terms of tapering.

[TEXT GRAPHIC]  
**Steps to Consider Now:**  
- Securities with shorter-term maturities may address rising interest rate risks  
- Ensure diversity in your portfolio by looking at global fixed income

And so what we're advising is that investors consider the duration risk that they have in the portfolio like you talked about really coming in on a shorter-term maturity.

And we'd like our clients to think more globally. Diversification's going to be very important, the different kinds of quality fixed incomes that you own within your fixed income portfolio.

MS. BARTELS: Now Marty, I want to thank you so much for joining us.

MR. MAURO: Thank you, my pleasure.

MS. BARTELS: Please be sure to discuss these ideas with your advisor to see if they are appropriate for achieving your financial goals.

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