Rising Interest Rates Will Affect Your Investments — What You Should Know

The bond markets are extremely active, with interest rates constantly changing in response to a number of factors including changes in the supply and demand of credit, Federal Reserve policy, fiscal policy, exchange rates, economic conditions, market psychology and, above all, changes in expectations about inflation. Currently, rising interest rates and expectations for economic recovery are impacting bond prices. As interest rates change, so do the values of all bonds in the marketplace. If you are thinking about buying bonds, or have recently bought some, you need to be aware of the effect of rising rates on your holdings. Here are some questions you should consider.

Q **Now that interest rates have started to rise, how will that affect bonds?**

A Interest rates, which recently hovered at their lowest levels in 40 years, are rising. Just as bond prices go up when yields go down, the prices of bonds you own now will generally drop as yields — interest rates — go up.

Q **When rates go up, do all bonds lose the same value?**

A No, changes in interest rates don't affect all bonds equally. Generally speaking, the longer the bond's maturity, for example a bond that matures in ten years versus another that matures in two years, the more it's affected by changing interest rates. A ten year bond will usually lose more of its value if rates go up than the two year note. Also, the lower a bond's "coupon" rate, the more sensitive the bond's price is to changes in interest rates. Other features can have an effect as well. For example, a variable rate bond probably won't lose as much value as a fixed rate security.

Q **What should I do as interest rates rise? Should I hold onto my bonds or sell them?**

A If you buy a bond and hold onto it until it matures, which many investors do, rising rates won't have any effect on the income you receive. You simply redeem your maturing bond and get back par, or the face value, of the bond. In the meantime, you will continue to earn or accrue interest at the rate you expected when you bought the bond. Here's an example provided by Bloomberg, LP:

Example #1. Buy and Hold.

You buy a 10 year U.S. Treasury Note with a face value of $1,000 and an interest rate of 4.26%. If you keep the bond until it matures, you'll receive $42.60 each year for ten years, plus the original $1,000.

Q **What happens if rates go up and I need to sell my bonds?**

A If interest rates go up and you need to sell your bonds before they mature, you need to be aware their value may have gone down and you may have to sell at a loss. Remember bond prices move in the opposition direction as yield. Here's an example again provided by Bloomberg, LP:

Example #2. Sell before Maturity & Interest Rates have gone up.

An investor buys a 10 year U.S Treasury Note with a face value of $1,000 and an interest rate of 4.26%. If the investor sells the bond before it matures and interest rates have risen 2%, he or she would only receive $863.34 (plus any interest paid before the sale).

Q **At some point, though, rates will go down.**
What will happen if I sell then?

A If interest rates have gone down since you bought your bonds, the value of your bonds will have actually gone up, giving you what's known as a "capital gain." That's because your bond is worth more. Here's another example using the Bloomberg data:

Example #3. You Sell Your Bond Before It Matures & Interest Rates have gone down.

You buy a 10 year U.S. Treasury Note with a face value of $1,000 and an interest rate of 4.26%. If you sell your bond before it matures and interest rates have dropped 2%, you will receive $1,118.54 (plus any interest paid before the sale).

Q **What happens to my**
bond fund if interest rates rise?

A Since a bond fund doesn't have a specific maturity date, the chances are the fund's total return will go down. Total return encompasses both change in prices and interest rate payments. If interest rates rise, the values of bonds held by the fund would fall, negatively affecting total return. However, the fund will continue to receive interest payments from the bonds it holds and will pass them along to investors regularly, maintaining current yield. Bond fund investors also enjoy professional management and asset diversification.

Q **Besides rising interest rates,**
are there any other risks I should consider?

A Yes, virtually all investments carry some degree of risk that you might lose some or all of your investment. When investing in bonds other than government-guaranteed securities, it's important to remember that an investment's return is linked to its credit as well as market changes. The higher the return, the higher the risk. Conversely, relatively safe investments offer relatively lower returns. Bond choices range from U.S. Treasury securities, which are backed by the full faith and credit of the U.S. government and are free from credit risk, to bonds that are below investment grade and considered speculative. In assessing your tolerance for risk, ask yourself, "What will I do if my investment is not there when I need it?"

Q **Should I
buy bonds now?**

A Most personal financial advisors recommend that investors maintain a diversified investment portfolio consisting of bonds, stocks and cash in varying percentages, depending upon individual circumstances and objectives. You need to be aware of the risks, particularly now, of rising interest rates. But if you are planning to buy bonds and hold them to maturity, they will provide a predictable stream of payments and repayment of principal. Many people invest in bonds to preserve and increase their capital or to receive dependable interest income. Whatever your investment goals-saving for your children's college education or a new home, increasing retirement income or any of a number of other worthy financial goals-investing in bonds can help you achieve your objectives.