Oppenheimer & Co. Inc.
Spencer Nurse
Managing Director - Investments
500 108th Ave. NE
Suite 2100
Bellevue, WA 98004
425-709-0540
800-531-3110
spencer.nurse@opco.com
https://www.oppenheimer.com/spencernurse/

Rising Rates: Strategies for Managing Bond Risks

To estimate the impact of a rate change on a bond investment, multiply the duration by the expected percentage change in interest rates. For example, if interest rates rise by 1%, a bond or bond fund with a three-year duration might be expected to lose roughly 3% in value; one with a seven-year duration might fall by about 7%.

Federal Reserve monetary policies can affect the entire fixed-income market, and the prospect of rising interest rates is a major concern for bond investors. Regardless of the rate environment, however, bonds are a mainstay of investors who want to generate income or dampen the effects of stock market volatility on their portfolios.

Now that the Fed is raising rates toward more typical historical levels, you may have questions about how higher rates might affect your fixed-income investments and what you can do help mitigate the effect on your portfolio.

Rate sensitivity

When interest rates rise, the value of existing bonds typically falls, because investors would prefer to buy new bonds with higher yields. Bonds with longer maturity dates are generally more sensitive to rate changes than shorter-dated bonds. In a rising rate environment, investors may be hesitant to tie up funds for a long period. Thus, one way to address interest rate sensitivity in your portfolio is to focus on short- and medium-term bonds. However, keep in mind that, although these bonds may be less sensitive to rate changes, they will generally offer a lower yield than longer-term bonds.

A more specific measure of interest rate sensitivity is called duration. A bond's duration is derived from a complex calculation that includes the maturity date, the present value of principal and interest to be received in the future, and other factors. If there are two bonds with a particular maturity, the bond with the higher yield will typically have a shorter duration.

For this reason, U.S. Treasuries tend to be more rate sensitive than corporate bonds of similar maturities. Treasury securities, which are backed by the federal government as to the timely payment of principal and interest, are considered lower risk and thus can pay lower rates of interest than corporate bonds. A corporation could default on payments (though this is relatively rare), so corporate bonds typically offer higher yields in compensation for the higher risk. A five-year Treasury bond has a duration of less than five years, reflecting income payments that are received prior to maturity. However, a five-year corporate bond with a higher yield has an even shorter duration.

When a bond is held to maturity, the bond owner would receive the face value and interest, unless the issuer defaults. However, bonds redeemed prior to maturity may be worth more or less than their original value. Thus, rising interest rates should not affect the return on a bond you hold to maturity, but may affect the price of a bond you want to sell on the secondary market before it reaches maturity.

Bond ladders

Owning a diversified mix of bond types and maturities can help reduce the level of risk in the fixed-income portion of your portfolio. Another way to manage interest rate risk is to construct a bond ladder, a portfolio of bonds with maturities that are spaced at regular intervals over a certain number of years. For example, a five-year ladder might have 20% of the bonds mature each year.

Bond ladders may vary in size and structure, and could include different types of bonds depending on an investor's time horizon, risk tolerance, and goals. When short-term bonds from the lowest rung of the ladder mature, the funds are often reinvested at the long end of the ladder. By doing so, investors may be able to increase their cash flow by capturing higher yields on new issues. A ladder might also be part of a withdrawal strategy in which the returned principal from maturing bonds provides retirement income.

Building a ladder with individual bonds provides certainty as long as the bonds are held to maturity, but it can be expensive. Individual bonds typically require a minimum purchase of at least $5,000 in face value, so creating a bond ladder with a sufficient level of diversification might require a sizable investment. Diversification is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.

Mutual funds, ETFs, and UITs are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

A similar option involves laddering with bond exchange-traded bond funds (ETFs) that have defined maturity dates. Such ETFs typically hold many bonds that mature in the same year the ETF will liquidate and return proceeds to shareholders. Bond ETFs may enhance diversification and provide liquidity, but unlike individual bonds, the income payments and final distribution rate are not fully predictable.

Another option is to purchase unit investment trusts (UITs) with staggered termination dates. Bond-based UITs typically hold a varied portfolio of bonds with maturity dates that coincide with the trust termination date, at which point you could reinvest the proceeds as you wish. The UIT sponsor may offer investors the opportunity to roll over the proceeds to a new UIT, which typically incurs an additional sales charge.

Bond funds

Bond funds — mutual funds and ETFs composed mostly of bonds and other debt instruments — are subject to the same inflation, interest rate, and credit risks associated with their underlying bonds. Thus, falling bond prices due to rising rates can adversely affect a bond fund's performance. Because longer-term bonds are generally more sensitive to rising rates, funds that hold short- or medium-term bonds may be more stable as rates increase.

Bond funds do not have set maturity dates (with the exception of the ETFs discussed above), because they typically hold bonds with varying maturities, and they can buy and sell bonds before they mature. So you might consider the fund's duration, which takes into account the durations of the underlying bonds. The longer the duration, the more sensitive a fund is to changes in interest rates. You can usually find duration with other information about a bond fund.

Although helpful as a general guideline, duration is best used when comparing funds with similar types of underlying bonds.

A fund's sensitivity to interest rates is only one aspect of its value — fund performance can be driven by a variety of dynamics in the market and the broader economy. Moreover, as underlying bonds mature and are replaced by higher-yielding bonds within a rising interest rate environment, the fund's yield and/or share value could potentially increase over the long term. Even in the short term, interest paid by the fund could help moderate any losses in share value.

It's also important to remember that fund managers, who typically have some latitude, might respond differently if falling bond prices adversely affect a fund's performance. Some might try to preserve the fund's asset value at the expense of its yield by reducing interest payments. Others might emphasize preserving a fund's yield at the expense of its asset value by investing in bonds of longer duration or lower credit quality that pay higher interest but carry greater risk. Information on a fund's management, objectives, and flexibility in meeting those objectives is spelled out in the prospectus and also may be available with other fund information online.

Floating rates

Adding a floating-rate component to a bond portfolio may also provide some protection against interest rate risk. These investments (long offered by U.S. corporations) have interest payments that typically adjust based on prevailing short-term rates.

The U.S. Treasury started issuing floating-rate notes with two-year maturities in January 2014. Investors receive interest payments on a quarterly basis. Rates are tied to the most recent 13-week Treasury bill auction and reset weekly, so investors are paid more as interest rates rise and less as rates fall.

Keep in mind that the path and pace of interest rate changes may be difficult if not impossible to predict. So you should focus more broadly on the degree of risk you are willing to accept in your bond portfolio and the important role that fixed-income investments play in your overall financial strategy.

The return and principal value of individual bonds, UIT units, and mutual fund and ETF shares fluctuate with changes in market conditions. Fund shares and UIT units, when sold, and bonds redeemed prior to maturity may be worth more or less than their original cost. Supply and demand for ETF shares may cause them to trade at a premium or a discount relative to the value of the underlying shares. UITs may carry additional risks, including the potential for a downturn in the financial condition of the issuers of the underlying securities.