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# 7 INVESTMENT STRATEGIES TO ENHANCE INCOME AS INTEREST RATES RISE

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# Rising Interest Rates
# OVERVIEW

Interest rates have been hovering near historic lows for an extended period of time. Because of the length of these historic lows, it may be easy to become complacent and believe that this trend will continue. However, what goes down will eventually go up, and that is why it is necessary to prepare your portfolio for this eventuality. As the economy rebounds, interest rates will begin to rise, and as this happens, fixed-income assets such as bonds will be affected. Unprepared investors may miss out on opportunities to increase their income and mitigate losses. **Following are seven strategies that may help enhance income as interest rates rise.**

1

# Keep Your Duration Low

What is duration? Duration measures how sensitive the price of a bond is to interest rate movements. The longer the duration, the more sensitive the price will be to any interest rate changes. When interest rates go up, bond prices go down, and longer-duration debt is impacted the most. Factors such as a bond's yield to maturity and coupon rate can affect it's duration, but as a general rule of thumb, for every 1% change in interest rates (increase or decrease), a bond's price will change approximately 1% in the opposite direction, for every year of duration. To put this into context, if a bond has a duration of 10 years and interest rates rise by 1%, then the bond's price will drop by approximately 10%. Therefore, if interest rates are expected to rise, a prudent strategy for investors to adopt would be to hold bonds or bond funds with shorter duration as the bond prices are less sensitive to changes in interest rates.

You can shorten the duration of your bond holdings by replacing longer-term bonds in your portfolio with shorter-term bonds of the same quality. Bonds with short and medium-term maturities are less sensitive to interest rate increases than longer-maturity bonds that lock into rising rates for more extended time periods. However, short-term bonds provide less income earning potential than longer-term bonds. To offset this, consider pairing short-term bonds with other instruments, including floating-rate debt, to take advantage of income opportunities.

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# Increase Floating-Rate Exposure

Unlike traditional bonds and bond funds that pay a fixed rate of interest, a floating-rate fund invests in financial instruments that pay a variable or floating interest rate. These interest payments fluctuate in line with prevailing interest rate levels as the fund aims to provide investors with flexible interest income in a rising rate environment. The main advantage that floating-rate bonds have over traditional fixed-rate bonds, is that interest rate risk is largely removed from the equation. While an owner of a fixed-rate bond can suffer if prevailing interest rates rise, floating rate notes will pay higher yields if prevailing rates go up. As a result, they will tend to perform better than traditional bonds when interest rates are rising.
By increasing your exposure to these types of instruments, you're also taking advantage of income opportunities because they are indexed against inflation.

# 3

# Increase Exposure To Inflation-Friendly Instruments

Real assets, such as real estate and commodities, typically have a high correlation to inflation and have underperformed the broader market over the past decade. Historically, real assets tend to rise in value when traditional asset classes (such as stocks and bonds) fall. We like the negative correlation that it offers to potentially decrease volatility in our portfolios.

Other inflation-friendly instruments are stocks in companies that are significant consumers of raw materials. Because the price of raw materials tends to remain stable or decrease when interest rates rise, companies using raw materials for their operations or to produce finished goods may see a corresponding increase in profit margins as their costs drop.

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# Seek Currency Diversification Through Foreign Bonds

Many U.S. investors have home bias, meaning that their portfolios are primarily made up of assets that are in U.S. dollars. Because these assets are easy to understand, investors tend to be more comfortable with them. However, it makes good sense for U.S. investors to dedicate a portion of their portfolio to foreign assets. Not only do they allow for currency diversification, but they also give investors diversification to many different yield curves. Moreover, other countries have many differing inflation policies and interest rates, so by buying foreign bonds, a U.S. investor diversifies their exposure to different interest rate cycles, which adds value to their overall portfolio.

Bond prices and interest rates have an inverse relationship, so if U.S. interest rates are expected to rise, then U.S. bond prices would be expected to fall. Knowing this, we feel that it would be wise for U.S. investors to start buying foreign bonds in countries whose economies are not recovering from Covid-19 as well as the U.S. They are more likely to keep interest rates lower to assist in an economic recovery.

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# Take On Some More Credit Risk to Benefit From An Improving Economy

The Federal Reserve raises interest rates in order to slow inflation and return economic growth to more sustainable levels. So once the country officially begins the process of re-opening, the Federal Reserve will want to make sure that the economy is rebounding at a healthy pace, and they will do so over time through gradual interest rate hikes. One of the ways investors can benefit from this rise in rates is by investing in Business Development Companies (BDC's) who thrive as rates rise due to their "floating rate" loan component. BDCs primarily provide floating rate loans to client companies and interest on these loans can be attractive when compared to fixed-income instruments issued by larger and more credit worthy companies. Potential investment benefits include a degree of protection if interest rates rise as well as high current income and capital appreciation. Therefore, BDCs can be an attractive alternative for yield-seeking investors.

It is important to note that BDCs invest primarily in debt securities that may be below investment-grade, and equity securities of financially troubled companies, many of which are privately held and lack publicly available information. These factors can add a degree of risk to investor portfolios. Collateralized Loan Obligations (CLO's) should also be considered in a rising rate environment because the loans that CLO's purchase have floating interest rates, meaning that like BDC's, their yields move up as interest rates move up. CLOs are designed to take an overall pool of loan debt (typically, commercial loans extended to businesses), divide it into investable pieces, and redistribute the cash flow to investors. Because the loans that they invest in feature floating-rate yields, they may not directly suffer the same adverse effects from rising rates as traditional fixed-income investments.

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## Invest In High Dividend-Yielding Equities

Currently the S&P 500 Dividend yield is around 1.44%. With the 2-year treasury at .15%, dividend stocks can bring more yield and add to the overall diversification of your portfolio. Historically, the Beta of a dividend stock portfolio, which is the volatility measurement of a specific portfolio compared to the market, has been lower than a traditional index fund, which is designed to mirror the volatility of the broader market.

So while High Dividend yielding stocks do come with some risk, it is still less than the overall stock market risk. Adding higher dividend yielding stocks to your portfolio, which are currently yielding about 3%, can give you more exposure to sectors that normally outperform the market as we move into an economic expansion period like we are now. Such sectors include consumer cyclicals, financials, industrials, information technology, and raw materials.

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# Allocate A Portion Of Your Portfolio To Emerging Market Debt

Emerging market (EM) debt brings higher yield and diversification to your portfolio. Currently, the yield has moved up to 4.5%. Certainly, Emerging Market debt comes with additional risk, but their lower correlation to other debt instruments will benefit your overall portfolio. EM debt has typically moved in the opposite direction to the dollar, and as the US dollar strengthened to start 2021, this has been negative for EM Debt. However, as the rest of the world begins to have more success with COVID-19 vaccine distribution, we see this reversing.

Not all (EM) Debt stories are the same. Different government actions that were taken during COVID-19 have led to a deterioration in global sovereign balance sheets. Although emerging-market government debt entered 2020 at its highest level since 2002, some analysts believe that the ability to finance the debt by these governments will remain relatively manageable.

There are countries classified by analysts as “high quality” based on sound solvency metrics and high institutional credibility levels. As a result, they retained significant flexibility in funding their COVID-19 crisis response efforts. High-quality countries may run more significant fiscal deficits but still be better positioned for a growth rebound. Check with your advisor on “high quality” (EM) Debt alternatives.

This document highlights just a few of the strategies our financial advisors help clients with every day. If you would like to speak with an advisor regarding this document’s contents or other financial planning and investment matters, please reach out to StrategIQ® today. Please see contact information and disclosures on the next page.

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