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Over the past four years the United States economy has experienced a prolonged period of historically low interest rates for everything from money market funds and bank CD’s to long maturity bonds. These low interest rates have applied to Municipal Bonds, U.S. Treasury securities, Corporate Bonds and the Mutual Funds, ETF’s and Closed End Funds that own them. The cause of these low rates can be attributed to a couple of factors. First, the U.S. Federal Reserve has made a concerted effort to keep interest rates low in order to improve the prospects of a recovery in the economy. Secondly, the slow pace of recovery in the economy since the 2008 recession in combination with a very badly damaged housing market has meant that there has been little demand for borrowing which has also kept a lid on interest rates. We are now at a juncture in time when a strengthening economy and an improving housing market may begin to put upward pressure on interest rates. It is very important that investors understand how their portfolios could be impacted if we enter into an extended period of rising interest rates.

For investors holding individual bonds issued by corporations or municipalities, an environment of rising interest rates will cause a decline in the market value of the bonds. The amount of the decline will be greater for those bonds that don’t mature for a long time than it will be for bonds that mature in the near future. The decline will also be greater for those bonds that have a low coupon payment than for those with a high coupon payment. This decline in value does not result in a loss unless the bonds are sold prior to maturity. If the bonds are held until maturity and the issuer remains solvent then investors will receive the par or face value of the bonds. One benefit of a rising interest rate environment is that the interest and principal payments can be reinvested at higher interest rates. For those investors that have a portfolio of bonds it is important to review the maturities and coupons with your investment advisor to understand what will happen if interest rates do indeed begin to steadily increase.

Many investors choose to own bonds through a mutual fund rather than to buy individual bonds as this has the advantages of greater diversification in combination with professional management. Unlike holding individual bonds, however, the bonds in a mutual fund are constantly being bought and sold in a fashion that, as described in the mutual funds prospectus, is intended to maintain a targeted constant maturity. This means that, unlike holding individual bonds, there is no set time when principal is returned to bond holders. Therefore the share value of a bond mutual fund could experience a permanent decline during a period of rising interest rates. Once again, investors should review the average maturity and coupon holdings of their bond funds with their advisors to determine what impact a general increase in interest rates will have and what mitigating action, if any, should be taken.

A rising interest rate environment can also have a negative impact on certain sectors of the stock market. For example, much of the rally this year in the US market has been led by sectors long associated with high dividend yields such as Utilities and Telecom companies. Investors have poured into these sectors in search of yields that they haven’t been able to find in the bond markets. When general interest rates rise, however, these sectors often decline in value as investors rotate into other sectors of the market that historically have done well in a rising interest rate environment. Additionally, there are many individual companies with highly leveraged balance sheets who will be negatively impacted by having to pay higher interest costs. It is just as important for investors to review the impact of higher interest rates on their equity holdings as it is for the bond holdings.

It is important to understand that rising interest rates aren’t necessarily a bad thing for investors and might well signal a welcomed improvement in the health of the economy. An exercise that is well worth taking with your investment advisor is to develop an understanding of the steps that need to be taken, if any, to reposition your portfolio should this environment begin to change.