Diversify income sources to improve returns when interest rates rise

Rising interest rates lower bond prices

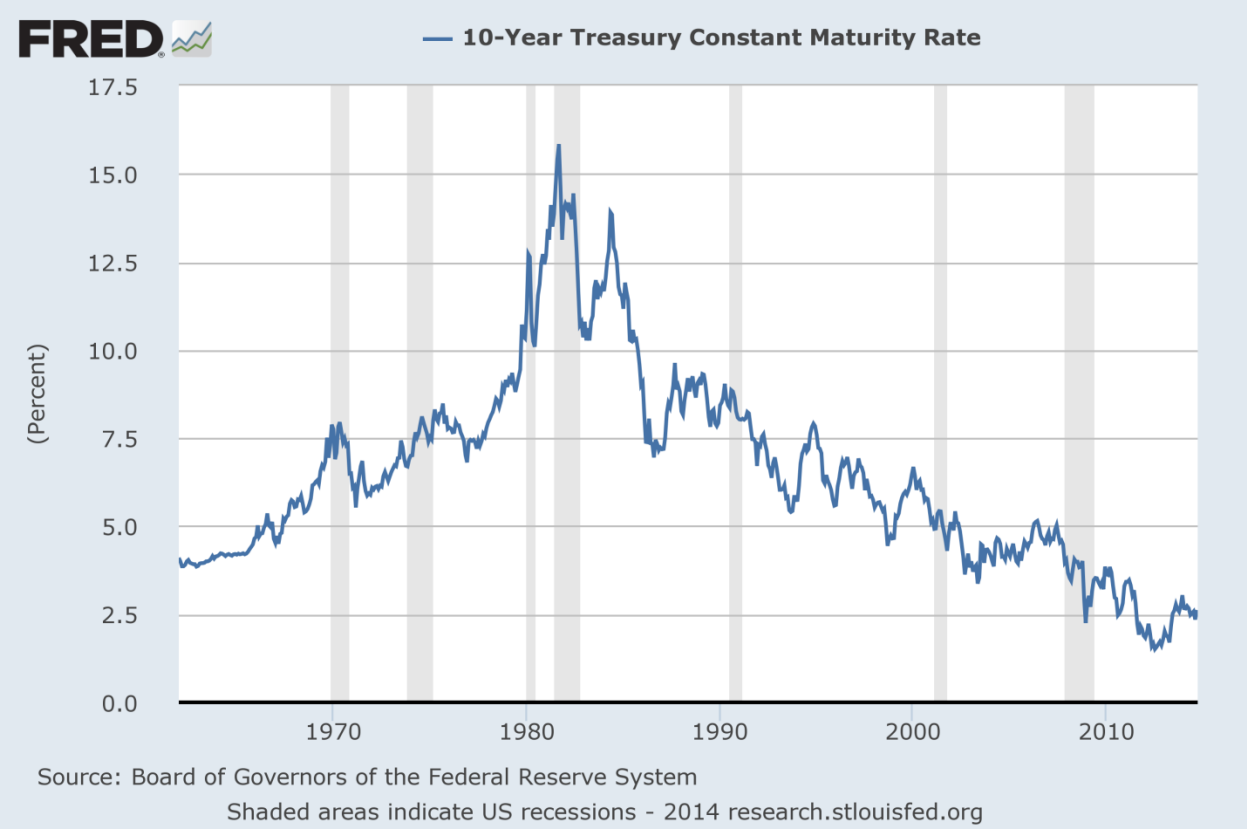
Bonds are securities issued by an entity, which could be a government or corporation. Investors loan the entity funds when they purchase a bond in exchange for interest or coupon paid periodically (usually semiannually) and return of amount invested (par value). When market interest rates increase, the bond price declines as coupons and principal received in the future are worth less now. Also, entities increase coupon rates on newly issued bonds to reflect new interest rates.

Duration estimates how sensitive a bond or bond portfolio is to changes in interest rates. It measures the percentage change that may take place with a 1% change in interest rates (usually U.S. Treasuries). For example, a bond with duration of 4 will likely lose 4% if interest rates rose 1%. Duration for a 5 year maturity bond with semiannual coupons is lower than the duration of a zero coupon bond with the same maturity. Interest payments received sooner are worth more currently. The duration of a zero coupon bond is equal to its maturity.

To obtain a better approximation of how bonds are affected by interest rate increases, one can take the duration percentage change and add the yield that the portfolio is paying. Let's say the bond with duration of 4 yields 2%. Therefore, the bond's 4% loss will be reduced to 2%, as the yield offsets part of the loss.

The period of low interest rates may be ending soon

Conversely, bond values rise when interest rates decline. Since their peak in the early eighties, Treasury bond yields have declined steadily reaching an all-time low of 1.38% in 2012. Bonds in all sectors including governments and corporates have enjoyed over 30 years of rising returns. The Federal Reserve has aggressively cut short term interest rates and bought bonds to spur economic growth after the 2008 financial crisis. Over the past two years, U.S. economic growth has accelerated and employment has improved. Investors are wondering about timing of Federal Reserve rate hikes to prevent inflation. Given that bond yields are still close to record lows and bond prices are high, it is a good time to review bond portfolio holdings to mitigate the negative impact of rising rates.



Protect your portfolio by reducing duration and improving yield

Lowering duration reduces sensitivity to rising rates. We suggest using short or intermediate bond portfolios that have duration lower than their benchmark. Vehicles include mutual funds, ETFs or separately managed accounts. Avoid vehicles that have high expenses as such fees eat into the yield the investment generates. Bond funds with spreads above U.S. Treasuries including investment grade corporate and non U.S. corporate may provide higher yields offsetting the negative price impact caused by higher rates. Firms may be able to pay their debts faster as economic conditions improve and default likelihood decreases. Investors will likely pay more for a bond with a higher yield and a lower default risk which in turn narrows the spread between corporate yields and Treasuries. While high yield bonds have benefited from spread compression in the past 6 years, they may be more expensive relative to other spread bonds.

Floating rate funds benefit from increases in interest rates. Their coupons are based on variable rates like London Interbank Offered Rate (LIBOR) and such coupons rise when the variable rate increases. These funds have low duration, usually less than 1, and yield close to 3%. The prices of floating rate funds may rise when market rates increase as their duration is less than the yield paid. For example, a floating rate fund with 0.3 duration and 3 yield will probably increase in price by 2.7% when interest rates increase 1% (3% yield minus 0.3% price decrease).

Flexible funds attempt to reduce duration and improve yield as interest rates rise. These investments, usually mutual funds or separately management accounts, can invest in a broad array of bonds. They may include U.S. government, corporate investment grade, high yield, asset backed and international bonds. These vehicles can structure portfolios with duration of less than one. Yields may be higher

relative to investment grade short or intermediate funds that are constrained to a specific duration range.

Investors can use preferred stocks, real estate investment trusts (REITs) or master limited partnerships (MLPs) to improve yield. Preferred stocks are a hybrid security; they pay a fixed dividend rate and trade in equity exchanges. The dividend rate can be higher than 5%. Preferred stocks may also benefit from price increases reflected in the firm's common stock. Both REITs and MLPs pay dividends to investors that can exceed 5%. These vehicles use their business structure to pass on income to investors and gain favorable tax treatment under U.S. laws. Investors need to consider how these vehicles fit within their goals and risk profile as they can be more volatile than bonds.

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Derrick received his MBA from Lehigh University and is a Martindale-Rauch Business Scholar. He has earned the designation of Certified Wealth Strategist.

After college he spent 3 years in the pharmaceutical industry and then went on to run and own several businesses including Handwerk Multi Family Office.

Handwerk Multi Family Office works with small business owners and families who are affluent. Over 50% of his family office clients are physicians.

Derrick is available to speak at regional or national events and many of the articles he publishes are a result of questions or issues sent in by readers via email. Please email financial questions or requests for speaking engagements to derrick@handwerkmfo.com.

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Investors should consider the investment objectives, risks and charges and expenses of the funds carefully before investing. The prospectus contains this and other information about the funds. Contact Derrick Handwerk at 2293 Locust Drive, Lansdale, PA 19446 or 215-238-0212 to obtain a prospectus, which should be read carefully before investing or sending money.