Interest Rate Risk

INVESTMENT STRATEGY

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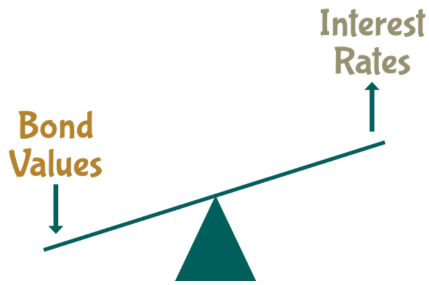
Many investors are unaware that there is usually an inverse relationship between fixed rate bond prices and interest rates. In other words, fixed rate bonds can lose value when interest rates rise. This situation is known as "interest rate risk." Since many investors have not experienced an extended period of rising interest rates or falling fixed rate bond prices, they may not realize that "safe" bond investments can sometimes hurt them financially.



How Interest Rate Risk Works

Let's consider an example that may help illustrate this concept. Assume you buy a 10-year fixed rate bond, yielding 3% interest for $10,000. You will receive $300 a year for ten years and will get your $10,000 back at the end of ten years—assuming the issuer is still solvent. After two years, you will have eight years remaining on your bond. However, interest rates have risen in the marketplace and an 8-year bond that can now be purchased for $10,000 is yielding 5%. Why would someone want your "old" bond yielding 3% when they could now buy a "new" bond that would get them 5%? The answer is that they wouldn't—unless your bond was repriced to be sold at a lower price—referred to as "discount" in the fixed income world. Like a teeter-totter, as interest rates rise, the value of fixed rate bonds decrease. In this case, the bond you paid $10,000 for would now be worth about $8,700. You can still hold the bond until maturity, but you'll have to wait eight more years to receive your $10,000 back.

Duration

"Duration" is a term used in fixed income investing to measure interest rate risk. "Modified duration" is how much a bond will lose in value, given a 1% or 100 basis point increase in interest rates.

The longer the bond's maturity, the greater the interest rate risk. If you have a 2-year fixed rate bond and interest rates rise, you only need to wait two years to receive your principal back. However, if you hold a 30-year fixed rate bond, a substantially longer time frame, that bond's value losses will be magnified. In simple terms, a bond with a duration of 2 loses 2% of its value if interest rates rise by 1%. A bond with a duration of 30 loses 30% of its value if interest rates rise by 1%.

Longer maturity bonds equal higher duration which also equals higher price risk.

"Chasing yield" can be a futile approach, especially in a high interest environment. As financial writer, Raymond DeVoe Jr., has famously put it: "More money has been lost reaching for yield than at the point of a gun." Retirees are often targeted by the unscrupulous with claims of high yielding investments. These investments may look appealing as retirees are often looking for a stable source of income. However, the risky nature of this type of investment—where the yield may be more than offset by investment losses—is often not explained.

In recent decades, bonds have worked well to diversify a stock portfolio, partially due to falling interest rates that have boosted bond values. In a climate with the potential for rising interest rates, it is important to recognize the inherent risks of fixed rate bond investing. While fixed rate bonds still play a role in a diversified portfolio, investors may want to look for new strategies to further reduce stock market risk. We recommend broad diversification by asset class as a prudent path when developing your investment portfolio.

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