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Interest Rates and Investing

ADJUSTING YOUR PORTFOLIO AS INTEREST RATES FLUCTUATE MAY PROTECT YOUR ASSETS FOR THE LONG RUN.

Interest rates are almost always on the minds of investors. If rates go up, stock and long-term bond prices fall. If rates go down, prices tend to rise—but investors can never really be sure when those changes will happen. And, unlike earnings announcements or scandalous company news, the impact of interest rate fluctuations on stocks and bonds often happens gradually.

There are all kinds of interest rates, from bond rates to mortgage rates to credit card rates. The most influential interest rate that the markets watch is the fed funds rate, which is the rate that banks charge to lend money to one another and which is set by the Federal Reserve. Typically, the Federal Reserve will raise rates to slow inflation, which hurts the economy because it inflates prices and erodes profits. The fed funds rate also trickles down to other rates in the market.

Since the beginning of 2004, the Federal Reserve has raised the fed funds rate 17 times, with most hikes occurring in 2005. The Fed last raised rates in July 2006, and it looks like they might hold steady for the near future. But what the Fed will ultimately do is always a source of debate among economists and financial professionals.

All of this can seem like a headache for the average investor, for whom interest rates are often a mystery. “Rising interest rates can be good news or bad news,” says Campbell R. Harvey, a professor at the Fuqua School of Business at Duke University in North Carolina. “They are bad news if inflation is expected to go up. They are good news if good growth opportunities are in the economy. The key is to know the difference.”

Harvey says it is important for average investors not to try and time the market based on what is happening with interest rates. Instead, he says, investing your money correctly should be left to a solid financial advisor. “Find someone whom you trust,” he says. “You want someone whose job this is to recognize all these opportunities and changes in the market.” In other words, when it comes to adjusting your portfolio in response to changing interest rates, watching CNBC is not enough.

With interest rates high and the future always uncertain, investors need to be prepared for rate changes in either direction. No one knows with absolute certainty what interest rates will do. The key is to minimize your exposure to interest rate risk; doing that will help you maintain and grow your assets. Here are some strategies you can discuss with your financial advisor.

PROTECTING YOUR BOND PORTFOLIO

Bonds are the most susceptible to interest rate risk, which explains the large impact a change in current interest rates will have on the value of your portfolio. Long-term bond prices fall when interest rates rise because investors will seek a bond trading at a discount as opposed to a bond trading at a premium due to the interest rate fluctuation.

One way to limit the interest rate risk to your bond portfolio is by using a strategy called laddering. Rather than investing one large amount into one bond with a fixed maturity, divide your investment across many bonds with varying maturities and yields. That way you have long-term and short-term bonds in your portfolio. For example, you purchase one bond

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with a one-year maturity, another with a three-year maturity and another with a 10-year maturity. If rates go up, you can take the money from the short-term bond when it matures and invest at a higher rate. If they fall, you can reinvest the money from the shorter-term bonds without having to sell off your other bonds (which are now worth more).

Laddering essentially allows you to diversify your bond portfolio against interest rate changes, just like mutual funds allow you to diversify your stock portfolio against fluctuations in the stock market.

One mistake some people make is getting out of bonds altogether when rates start to move a lot. This isn't the best course of action, because bonds do provide stability to your

portfolio, as well as a steady income stream for reinvesting. Laddering, rather than withdrawing, is a smarter move because, at the very least, it allows you to maintain your asset base.

STOCKS AND INTEREST RATES

When it comes to fluctuating interest rates, the key to your equity investments is diversification. Be wary of owning stocks solely in industries susceptible to interest rate changes, such as mortgage lending and car manufacturing. These industries tend to be affected more quickly than others.

If rising rates are pushing your stocks down, you should consider allocating your portfolio heavily in short-term bonds, money market funds, and perhaps even a market-neutral hedge fund. The timeline as to when rates will actually begin to bring down a certain stock price is best left to your financial advisor.

As with all investment strategies, it is important that you talk to your financial advisor about the possible effect interest rates will have on your portfolio. Your financial advisor can make sure your portfolio's risk is properly managed and has the potential to grow no matter what interest rates may do. ■

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