Effects of Rising Interest Rates on Fixed Income Investments

For the greater part of the last 30 years, declining interest rates have boosted total returns on fixed income and provided a tailwind to bond investors. In 2012, interest rates touched a modern era low with the 10-year Treasury rate declining to 1.38%. Since that low, rates have started to increase with the 10-year treasury closing out 2013 at around 3.02%. Despite the fact that rates have declined about 0.5% as of May 2014, many economists believe that interest rates are likely to increase over the intermediate term.

What effect might a rising interest rate environment have on fixed-income investments?

To answer this, investors need to be aware of two important factors:

- An inverse relationship exists between interest rates and bond prices
- Duration is the measure of interest rate risk for bonds

The inverse relationship between interest rates and bond prices

Bond prices are inversely correlated to interest rate changes. This means that as interest rates fall, bond prices increase, and as interest rates rise, bond prices decrease. A simple example illustrates why this is the case: Assume the market rate of interest is 4% when Company A issues a two-year bond that pays 4% annually. At the end of one year, the market rate of interest has moved up to 5%. Company B issues a one-year bond which will pay 5% over the next year. An investor has the option to purchase the Company A or Company B bond. Both have one year left until the bonds mature. Because Company A’s bond will pay less interest over the next year than Company B’s bond, it should be worth less to investors. In fact, the price of Company A’s bond generally will fall proportionately, so that an investor can purchase either bond A or bond B and earn the same rate of return, which in this example is 5%.

Duration: the measure of interest rate risk for bonds

The fluctuation of a bond’s price resulting from interest rate movement is known as interest rate risk. A bond’s level of interest rate risk is measured by “duration.” A bond’s duration provides the approximate price change the bond would experience if interest rates moved by 1%. As an example, assume a bond has a duration of 5 years. If interest rates increased by 1%, the value of the bond would fall by approximately 5%. Similarly, if interest rates decreased by 1%, the value of the bond would increase by approximately 5%.

Duration has the same effect on bond funds. Because of the relationship between duration and interest rates, the longer a bond’s duration, the more volatile its price will be in response to a change in interest rates (e.g., the price of a bond with a duration of 10 years will be more volatile than the price of a similar bond with a duration of two years). If you know a bond’s or bond fund’s duration, you can estimate how it will react to a change in interest rates. Keep in mind that price fluctuations only matter if you want to sell a bond before maturity—if you intend to hold the bond until it matures (and there is no default), you will receive your full principal investment back at maturity.

Be Prepared

Fixed-income investments are an important part of many portfolios and will continue to be—even if interest rates start going up. The performance of the various asset classes tends to vary, sometimes dramatically, from year to year, and it’s impossible to predict when interest rates will rise and by how much. That’s why it’s usually wise to diversify across a variety of investments. If interest rates increase dramatically, it will have a negative effect on the value of fixed-income investments, especially ones with longer duration. Investors with a fixed-income allocation in their portfolio should meet with their Advisor and ensure they understand the effect of rising interest rates on their overall portfolio.

For additional information, see FINRA’s Investor Alert, Duration—What an Interest Rate Hike Could Do to Your Bond Portfolio (http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318).