The Capital Advisor presents II:
A Corporate Treasurer's Guide to Investment Challenges

How to Weather a Rising Interest Rate Environment

There are several portfolio management techniques available to help diminish the risk presented by higher interest rates. If fact, when managing portfolio duration, yield curve positioning and security selection properly, rising interest rates can add value, particularly for short duration or held-to-maturity portfolios.

Duration Management
Though it is extremely difficult to predict with precision how quickly and to what extent interest rates will shift, we believe investors should resist moving all fixed income assets into an overnight fund for fear of losses. In overweighing your money market fund allocation, you are likely to substantially reduce portfolio yield as you give up the higher yields provided by bonds with longer maturities. Moreover, the loss in yield could be magnified if the pace of interest rate increases was slower and their magnitude less severe than predicted.

In our opinion, the key is to strike a logical balance between reduction in duration to protect principal and investment in higher yielding securities. An investor should assess his or her tolerance for potential unrealized market value losses and decide on a targeted portfolio duration. For example, a portfolio with a 12-month duration may stand to lose 1% of its value when rates move higher by 100 basis points. Once the targeted duration is established, an investor may then select investments that take advantage of the higher yields further out on the curve. It is important to note that when an investor holds a security to maturity, any unrealized losses will be erased as the bond approaches its final maturity date.

Yield Curve Positioning
When interest rates start to rise, not all bonds behave the same. Market expectations may cause yields on shorter bonds to rise more than longer bonds, or vice versa. An informed portfolio manager should be able to take advantage of the changing shape of the yield curve and increase the potential to achieve higher yields without changing the overall portfolio duration and its corresponding interest rate risk.

For example, a well-managed short-duration portfolio, with an appropriate structure of maturities, will allow for reinvestment opportunities as rates steadily rise. As individual bonds mature, the proceeds may then be used to invest at higher absolute yields. Alternatively, certain maturities along the curve may provide more incremental yield pick-up than bonds that are either shorter or longer. Lastly, a breakeven analysis of a money market fund yield can also provide valuable insight into which maturity buckets to utilize.

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Security Selection
The ability to select the appropriate mix of securities is another method to control interest rate volatility. Some well established bond investments are specifically designed to reduce interest rate risk. With a good understanding of their credit quality and relative yield attractiveness, an investor can add return without taking on additional interest rate risk. Examples of such investments include:

TIPS
A Treasury Inflation Protected Security, commonly referred to as "TIPS", is a U.S. Treasury issued bond that has its redemption value indexed for inflation based on the Consumer Price Index (CPI) readings. Since its redemption value will never fall below its face value, while earning a premium over inflation, TIPS may be a good weapon against higher interest rates.

Floating Rate Securities
A floating rate security (also referred to as floating rate note, or FRN) is an instrument whose coupon rises when the underlying reference rate (usually U.S. LIBOR or U.S. Treasury Bills) rises. They may provide additional yield opportunities relative to U.S. Treasury securities without taking on interest rate risk.

Corporate Bonds
Short duration corporate bonds of high credit quality typically provide incremental yield relative to U.S. Treasuries. This extra yield can help cushion the principal loss associated with rising interest rates.

Foreign Government Securities
U.S. dollar denominated, high-grade foreign government bonds, such as those issued by G-7 nations, may also provide interest rate protection, particularly when the markets view higher U.S. interest rates as being at least partly due to trade and fiscal deficits. In this scenario, yields of foreign government bonds should rise slower than U.S. securities.

Investors need to be cognizant of the risks associated with higher interest rates. Capital Advisors Group believes it is unwise to simply hide your cash in a money fund in a rising rate environment. A prudent, short-duration investment strategy can help to mitigate the risk of increasing rates, while allowing more flexibility to take advantage of improving yields.

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