Effect of Higher Rates on Fixed Income Portfolios – June 17, 2013

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In pursuing its highly accommodative monetary policies over the past five years, the Federal Reserve has steadily pushed down interest rates in an effort to stimulate economic growth. For example, in June 2007, just prior to the financial crisis, the yield of the 10 year US Treasury note was almost 5.30%, today it is around 2.15%. This decline in rates has generally benefited existing fixed income bondholders who have realized sometimes substantial price appreciation on their holdings as rates fell and bond prices rose.

Over the past month or so, interest rates have moved higher as economic indicators show signs the US economy could finally be on the road to recovery. In addition, a number of Federal Reserve officials have publically suggested it may be time for the Fed to shift policy which could lead to higher rates. This has prompted a growing number of market analysts and even some members of the Federal Reserve Board to caution investors that interest rates may rise causing a drop in prices for interest rate sensitive investments.

Certainly the price of a fixed income security, as with the price of a stock, can change on a daily basis, shifting up or down in response to changes in the market. However, a sustained increase in interest rates could have an adverse effect on the value of fixed income holdings. In responding to economic and interest rate developments, holders of fixed income securities should review their portfolio with their Financial Advisor and consider taking steps to mitigate the potentially adverse impact rising rates could have on security prices and portfolio value by considering selectively selling securities.

Risk To Fixed Income Portfolios

Fixed income securities, and by default fixed income portfolios, entail a degree of interest rate risk. In general, the longer the maturity of a security or the greater its duration *(an estimate of the change in price for a given change in yield)*, the higher the interest rate risk. Fixed income security prices are inversely related to interest rates and an increase in the rate or yield of a security results in a lower price. The specific change in price for a fixed rate security, given a change in interest rates, depends on the various attributes of the particular security: maturity, coupon, credit rating, call features, etc.; but invariably, the price of a fixed rate, fixed coupon security declines when interest rates rise. Such price decreases can occur even in the absence of any change in the credit rating(s) or other attributes of the security.

Many different types of investments experience price changes as interest rates change. In particular, interest rate risk is most often associated with fixed rate notes and bonds, such as US Treasuries, as well as corporate and municipal debt. Examples of other investments that may be exposed to interest rate risk include open-end (mutual) funds, closed-end funds, unit investment trusts, preferred stock, bond funds, as well as other types of investments that may have embedded interest rate risk such as utility stocks, REITs and MLPs.

Potential Price Change With Higher Rates

As noted above, the price of a longer-term fixed rate security is generally more sensitive to interest rate changes than a shorter term security. The chart below illustrates approximately how much the price of a given US Treasury security would decline for an immediate: +1.00%, +2.00% and +3.00% rise in interest rates.

Approximate percent change in the price of US Treasury note/bond with change in market rate/yield			
UST Maturity	Yield Change *up + 1.00%*	Yield Change *up + 2.00%*	Yield Change *up + 3.00%*
2 YR	-2%	-4%	-6%
5 YR	-5%	-9%	-13%
10 YR	-9%	-16%	-24%
30 YR	-18%	-31%	-42%

For example if $100,000 was invested in a 5 year Treasury note and the market yield/rate increased +2.00%, the price of the note would decline by roughly 9% and the market value would drop to $90,806.

General Considerations

- Fixed income investments are appropriate for most portfolios and can provide a steady stream of income. A diversified, well balanced portfolio can be useful in managing overall risk, as well as provide an appropriate level of return.
- Fixed income debt holders concerned with the effect rising rates may have on both individual fixed rate securities and fixed rate portfolios, should review their holdings and consider 1) selective sale/liquidation or 2) shortening of maturities as a prudent way to at least partially offset the potential market value deterioration associated with higher rates.
- Decisions about which securities would be the best sale candidates depend on the individual investor and their particular circumstances. We think that now is an appropriate time to review portfolio holdings with your Oppenheimer Financial Advisor to assure your portfolio is properly structured to address your individual goals and objectives.
- Although there is no certainty regarding the future direction of interest rates, we believe investors should be aware of the potential risks associated with fixed income investments as well as their rewards.

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