

## Spring 2010 Newsletter: Preparing for Higher Interest Rates

I wrote in my winter 2010 Newsletter that one of the most important lessons of the last decade for investors was the importance of keeping a close eye on the Federal Reserve's interest rate policy. ("It's the Fed, Stupid.")

So what is the Fed's next move and when will it happen? Answering the first question is much easier than answering the second. The Fed's primary tool in establishing its interest rate policy is targeting the Federal Funds Rate (FFR). Since the current target for the FFR is between zero and .25% ("near zero"), which as a practical matter cannot go much lower, the Fed's next move will in all likelihood be to raise the FFR. So the all-important question becomes "by how much?" and "when?" will the Fed raise the target for the FFR.

While all investors are interested in the answer to this question, fixed income investors are particularly so. This is because of the very direct sensitivity of bond prices to changes in the level of interest rates. Here is the rule. If interest rates go up, bond prices go down; the longer the maturity of the bond, the more the price of the bond goes down. Why?

Say you buy a high quality 5 year 5% corporate bond at a price of 100 (assume that your purchase price is \$1000). You now own a security that pays you a fixed amount (\$50 a year) of interest each year for 5 years and in addition pays you \$1000 at the end of 5 years. If a year later the interest rate on the issuance of a new similar quality bond has risen to 6%, your bond will not be worth \$1000 because its market price would have in all likelihood declined to the point where its yield would equal 6% (to be in line with the new bond). If your bond were a 10 year rather than a 5 year bond, the decline in market price would be greater (I should point out that a decline in current market value is not necessarily a bad thing for an investor who intends to hold the bond until its maturity because he knows that he is going to get his \$1000 back at that time unless the issuer has failed).

So how can a bond investor assess the interest rate risk of a particular bond or bond fund before he makes the investment? Bond analysts have developed a tool for measuring the sensitivity of a bond's market price to changes in the level of interest rates called "Duration". If an investor knows what the duration (measured in years) of the bond or bond fund he is considering purchasing is, he can determine approximately how much of a percentage change in price he can expect for a 1% change in the level of interest rates. For example, if the duration of a bond or fund is 3 years, then an investor who owns that bond or fund can expect approximately a 3% change in its market price for every 1% change in the level of interest rates. In the example above, if the 5 year 5% bond had a duration of 3 years, then the buyer of that bond could anticipate that the market price of the bond would decline 3% (to approximately \$970) if the level of interest rates increased from 5% to 6%. Offsetting this hypothetical \$30 unrealized loss of market value is the investor's receipt of the \$50 interest payment.

Which brings us back to the current state of affairs at the Fed. What level of interest rates will the Fed target in the future and when? Using duration numbers can help an investor

assess the risks of investing in bonds or a bond fund when interest rates are expected to rise. Let's say that an investor is considering whether he should invest in a bond fund yielding 2.8% with a duration of 1.8 years. If a future Fed move results in a 1% rise in interest rates (which would be a very significant move by the Fed), then the market value of bond fund is likely to decline by approximately 1.8%. Because the interest income on the fund would actually more than cover the loss of market value in this case, the investor might be willing to accept the risk of owning the fund.

What about the stock market investors? How do they assess the risk associated with the Fed's eventual move to target higher interest rates? Unfortunately for stock market participants, as opposed to their fixed income brethren, they are faced with a much tougher question, one that goes beyond a straightforward quantitative analysis. Historically, higher rate environments have not been good for stocks. But how much of the appreciation in the market since last March is at risk if rates rise? Conversely, how much more appreciation can we expect if the Fed continues its "near-zero" rate policy for an "extended period"?

I cannot answer these questions. Stock market participants do not have a duration-like tool for quantifying risk. All I can do is try to help my clients retain their investment flexibility. I continue to advise them to neither be overweight nor underweight in their asset allocation to stocks. We just don't know whether a painful correction or a continued march towards the market's old highs is lurking around the corner. Here is my list of "do's" in the current market environment:

1. Maintain a higher than normal cash position (don't worry about the very low return on your cash – think of it as a tactical asset).
2. Whether they are large or small caps, own high quality names with a track record, seasoned management and low debt (many quality companies have lagged the market's recent performance).
3. Build your portfolio on a stock-by-stock basis (look for companies that have "slipped off the radar", pay dividends and appear undervalued).
4. Include a few defensive names with higher than average dividend yields like the electric utility and telephone companies (these stocks have also lagged the market's recent performance).
5. Try to make counter-emotional investment decisions (look to buy at times of maximum pessimism, not when there is euphoria around investments that have recently outperformed).

Let's stay in touch so I can help you maintain a disciplined approach to investing. Talk to you soon.

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