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Rising Interest Rates and Fixed Income Investments

by Steven Podnos, Md, Cfp • July 6, 2015 • 2 min read • original

Bear with me, as the topic of rising interest rates is hard to make interesting. But, understanding the concept when evaluating fixed income investments can make a great deal of difference in knowing the risks you take.

Remember that fixed income investments in general involve you lending money to an entity (a corporation, a bank, a government, etc.) in exchange for a promise to pay you back both the original money lent (principal) and something extra for your time and risk (interest).

Time is important, as most of the time (with inflation), a dollar in the future is worth less (will buy less) than a dollar today. So, if I give you a dollar today as a loan, I'd want you to give me back more than a dollar when the money is returned —in order to buy the same amount of stuff if not more. I also want more back in the future to return an "after inflation" bonus to compensate for the risk of not investing elsewhere.

Then, we need to consider the other risks of lending money, such as the risk of not being paid back some or all of the promised sums (principal and/or interest). A country may repudiate its debt (Russia and Argentina come to mind), a company may fail (GM, Enron, etc.), or an investment bank can fail (e.g. Lehman Brothers). There are currency risks also if you choose to lend outside your home country.

But today, we'll focus on only the risk of interest rate changes. This risk is closely intertwined with that of time risk, as the effect of interest rate changes is magnified by longer periods of time. For example, you may lend $1,000 to the government by buying a U.S. Treasury bond. You have no real credit risk as the government can always just print the dollars to pay you back. You have no currency risk, as you are investing in your own country. But you have time and interest rate risk. If the bond you purchase pays a 3-percent interest rate and will redeem your original investment in one year, then if interest rates move up rapidly, you probably don't care. You'll have your money back in 12 months to reinvest at higher rates. But, if you lent the money for 3 percent for 10 years, interest rates increasing will cause you to suffer financially. It is important to remember that longer term fixed income investments are more sensitive to interest rate changes.

Most of the time, interest rates rise due to inflation, but our current yields are also being actively suppressed by government attempts to stimulate the economy. Rising interest rates for any reason can cause the same pain in your fixed income portfolio.

Let's imagine that inflation and interest rates rise from some lower value to 3 percent a year after you buy your bond. If the value of your dollars is dropping at the rate of 3 percent (inflation rate of the same), then after holding your bond for10 years, you have made no gains (and a loss after taxes). You can choose to wait out the return of your principal, losing both purchasing power and the opportunity to invest at higher rates during that time. Or you can sell your bond to someone else at a significant loss (in order for them to get market rates, they will pay less for bond).

As a rough rule, a 1 percent change in interest rates will move the price of a bond as a percentage of its duration (similar to maturity in most cases for this discussion). So, a current 10-year U.S. government bond has a duration of almost 9 years. If the interest rate on 10-year bonds goes up only 1 percent, the price of existing bonds will drop almost 9 percent to compensate. With the current yield of about 2 percent on the 10-year bond, you risk a loss equal to more than four years of interest with a measly 1 percent interest rate shift.

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