Interest Rates:

Riding the Bond Teeter-Totter

By

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Will the Interest Rate Teeter-Totter Have Retirees Living on Bread and Water?

Q – My bank is still paying me next to nothing for my CD's. Should I invest in bonds to generate income?

A – Wouldn't we love to live in a perfect investment world? That world would have the following:

- High Returns and
- High Liquidity and
- Low Risk

Regrettably, in this imperfect world, you can't have all three.

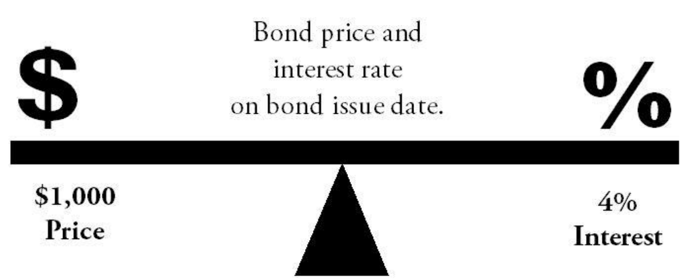
Many retirees who want to reduce the risk in their portfolios are seeking investments that still provide a nice return for their money. Here's the rub. If you want to increase your returns you basically have two choices:

1. Increase Risk
2. Decrease Liquidity (buy longer term investments)

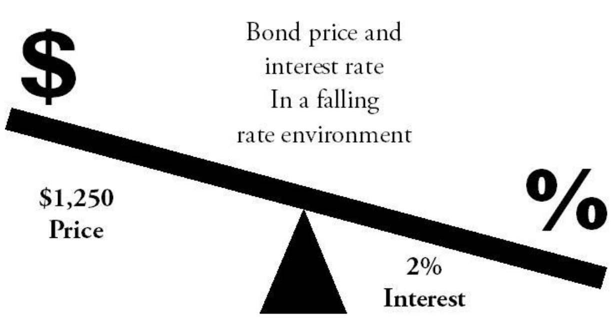
Traditionally many investment firms have turned to bonds. However, bonds are not risk-free investments. One of the risks is that of interest rate risk. This risk to the bond price occurs if you do not hold your bonds to maturity. To illustrate this, let's return to the playgrounds of our youth.

When we were children, we would play on teeter-totters with our friends. When we clambered aboard, the teeter-totter was parallel to the ground.

Similarly, at issue, the price and interest rate are at equilibrium. In the picture to the right, the price of the bond is on one end and the interest rate is on the other end. In this example, the issuer will receive $1,000 for the bond in exchange for a 4% interest rate. On the date that the bond matures, they will pay $1,000 to the bondholder (assuming they don't default on the bond in the interim).

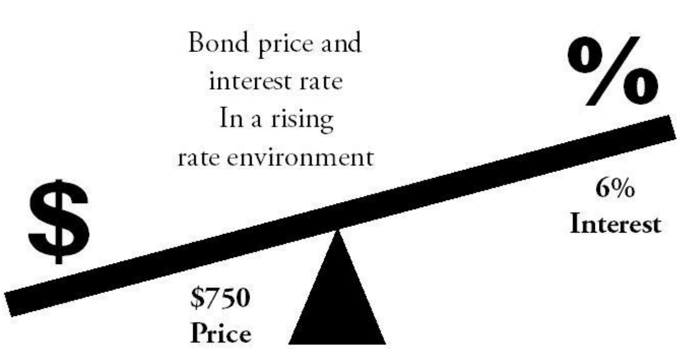


Between the issue date and maturity date, the teeter-totter will go up and down according to interest rates. There's an inverse relationship between bonds and interest rates.



The diagram to the left shows what might happen to this bond if interest rates fall. In the past few years we have witnessed this effect and it is the reason why many investors have made money in the bond market.

The problem that I see is what happens in a rising interest rate environment. The next illustration shows what might happen if interest rates rise.



I don't know about my readers, but when I was a kid, sometimes I would play on the teeter-totter with a not-so-nice friend. When I was at the top and she was at the bottom, my friend decided to play a trick on me and jump off the teeter-totter. All of a sudden, I came crashing to the ground. Ouch!

This summer bond investors experienced some of the same pain. On May 1, 2013, the interest rate on the 10 year Treasury was 1.65%. Four months later on August 22 it was 2.90%[1]

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This seems like a small increase – after all it is only 1.25%. However, the percentage increase was a whopping 75%! As a result, many bond investors have been thrown off their teeter-totters and are experiencing a pain in their portfolios.

I do not have a crystal ball and cannot predict the rise and fall of interest rates any more than I can predict the rise and fall of the stock market. However, if the government suspends its quantitative easing policy that has kept interest rates low, that fall off the teeter-totter that bond investors experienced this summer may feel like a walk in the park!

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Teresa Bear specializes in retirement planning and asset preservation for retirees and their loved ones. Teresa works primarily in the Phoenix Metro area and has offices in Mesa and Chandler.

Teresa has been helping families and retirees reach their financial, tax, retirement planning, and estate planning goals for over 25 years. She is legally bound to uphold the highest level of fiduciary standards when providing investment advice to her clients.

Author of the book, S*he Retired Happily Ever After*, Teresa is committed to educating clients and assisting them in reaching their financial goals.

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[1] http://finance.yahoo.com/q/hp?s=^TNX&d=7&e=31&f=2013&g=d&a=0&b=2&c=1962&z=66&y=66