Episode #214: How to Invest for Rising Interest Rates

Video Transcription

Hi. My name is Tim Devlin, and I want to welcome you to this week's episode of "Money Script Monday." Today, we're going to discuss how we can best prepare for a rising interest rate environment. Since roughly the mid-1980s, bond yields have been in a secular decline, culminated with the effects of the pandemic in 2020 where they reached near all-time lows.

This has had a huge impact on how we both allocate capital and make future investment decisions. As we reopen the economy and start to spur on that economic growth, we're also seeing an environment where interest rates are set to rise. Today, I want to speak on three things that we can address to better prepare yourselves for this.

The first is equity selection. The second is how we can best manage bond risk. Lastly, the third thing is how we may be able to take advantage of the record low-interest rates that we have today and lock those in for the future.

So first let's talk about equity selection. Interest rates act like gravity on stocks and stock valuations. What I mean by this is, if you think about if you were to jump on earth versus if you were able to jump on the moon, on the moon, because there's less gravity, you'd be able to jump much higher. Stock valuations operate in a similar manner.

When interest rates are very low, the stock valuations are allowed to rise. They're able to command a higher valuation. But as the interest rates start to rise again, these valuations come into question. A lot of the names that have dominated over the past decade, some of the mega-cap tech names that we know and love, they're great companies, but the reality is their valuations have become very expensive. So, these high-growth names are an area of risk in the market.

What we want to do is be wary of that risk and potentially rotate into what's known as value; rotate into cheaper areas of the market that are set to benefit from a reopening economy, an accelerating growth in the economy and a rising interest rate environment. We want to be wary of this dynamic between growth and value.

Secondly, what we want to do is manage what's known as bond risk. There are many different ways that we can address bond risk, but the one I want to talk about today is duration risk. Before we get into that, let's talk a little bit about how bonds move and their relationship between yield and price.

As interest rates begin to rise, the yields of the bond go up, prices begin to fall. Conversely, if rates were to fall, those prices were to go up. Regardless, if you own a 2-year bond or a 30-year bond, now that's when they mature in the future, this relationship maintains the same, but the difference is how much this impacts that bond.

If you own a 2-year bond, rates rising has a smaller effect on the price of the bond than it does the 30-year bond. The reason for this is, if you own a two-year bond, if interest rates go from 2% to 3% and you own a 2% yielding bond, you're able to reinvest that bond in a matter of two years. Whereas if you own a 2% bond maturing in 30 years, you have to wait 30 years to reinvest that bond at a higher rate. And so it's going to command a lower price.

What we want to do is stick to the lower end of the duration curve. We want a lower number of years in that bond portfolio so that we can manage this risk and not put you at risk of those bond prices falling greatly by having a very long duration on the bond.

The last thing I want to talk about is how we may be able to lock in these record low interest rates. This pertains more to your personal finance life.

If you think about your mortgage, maybe car loans, if you have any personal loans, right now you're able to take out these loans at a very affordable interest rate; that won't always be the case. As interest rates begin to rise, mortgage rates will begin to rise, these car loan rates will begin to rise. What we want to do is take advantage of your situation today. If you need to purchase something, take advantage of this interest rate.

On the other side of that is, if you have any variable rates with your loans, you may be able to convert that to a fixed rate and lock that in, where you don't have the risk of that interest rate rising and your variable loan going up as well.

Every situation in this category is going to be very different based on your personal finances, and that's why I encourage you to speak to your advisor. Have them take a look at the equity selection in your portfolio. Ask them, "Do we need to address how much I have in growth versus value?"

Ask them to take a look at your bond portfolio and have them address the different risks in that and if we need to make any changes. Lastly, have them look at your personal finances and see if we may be able to take advantage of those record low interest rates, and just utilize them to help you create a more comprehensive financial picture so that you can meet your goals.

I encourage you, reach out to your advisor, ask them to take a look and review your plan. And with that, I want to thank you for attending this week's episode of "Money Script Monday." Thank you.

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