As the Federal Reserve and other central banks wind down their fiscal stimulus programs, we at U.S. Trust agree with the widespread conviction that we are entering into an extended period of rising interest rates.

While we don’t foresee a return to the days of a 1970s-style spike in rates and inflation, we are most likely at the end of a 30-year bond rally. We believe the tail-wind from this long streak is over and that calls for a new look at the role that fixed-income plays in your portfolio.

I’d like to share a few strategies that we believe can help you maximize fixed income returns, as well as some thoughts on rising interest rates and their impact on bond values.

When rates rise, short-term bonds hold their value better than longer-term bonds. For example, if the yield on both 10-year and three-year Treasury notes were to rise by half a percent, 10-year notes already in your portfolio would lose about 4.5% of their value, while three-year notes would drop just 1.5%.

We believe this environment warrants a higher exposure to shorter-term bonds. This more frequent maturity schedule also allows the portfolio to “walk into” higher rates.

Buying and holding bonds might feel like the safest response to volatile markets. But systematically buying long maturity bonds at record low rates adds duration risk and locks in low yields. By contrast, prudent active management can respond to market volatility created by a variety of factors in today’s market, such as uncertainty of Fed policy, tax law changes, debt ceiling negotiations and geopolitical unrest. This volatility creates the ability to buy low, sell high and capture opportunity.
The benefits of active management are greater if the universe of investable assets is large and diverse. Because of their tax advantages, municipal bonds have long been the “go-to” option for high-income investors. In fact we find that market currently attractive. But they aren’t always the best choice.

At U.S. Trust, our Crossover Strategy Also considers corporate bonds, mortgage-backed securities, high yield, preferred securities, leveraged loans, Treasury Inflation-Protected Securities or TIPS, structured products, overseas and non-dollar bonds. We examine each of these on an after tax basis when we construct portfolios. With diligent selection and active management, these taxable bonds may often produce more attractive overall returns. The portfolio also enjoys better diversification.

With Treasury yields at or near record lows, we believe carefully selected securities with lower credit ratings will perform better than those with the highest ratings. For investors with the appropriate risk profile, we suggest considering bonds rated Triple-B or lower, as well as preferred securities, and leveraged loans. We prefer extra yield in the form of credit risk rather than longer interest rate risk.

Though it may take some time to manifest inflation will likely rise as interest rates increase. While we don’t expect sharp spikes, investors should begin to consider some inflation protection through TIPS or floating-rate securities.

Though rates are moving higher, fixed income remains an important component of a well diversified portfolio. I hope these thoughts help you consider ways to respond—and prosper—in a rising interest rate environment.
An approach based on your life and needs
IMPORTANT INFORMATION:

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Sector and asset allocation recommendations should be considered in the context of an individual investor’s goals, time horizon and risk tolerance. Not all recommendations will be suitable for all investors.

Diversification does not ensure a profit or protect against loss in declining markets.

Investing in fixed income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. Tax-exempt investing offers current tax-exempt income, but it also involves special risks. Income from investing in municipal bonds is generally exempt from Federal and state taxes for residents of the issuing state. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes and, if applicable, the alternative minimum tax (AMT).

Mortgage-backed securities are subject to credit risk and the risk that the mortgages will be prepaid, so that portfolio management may be faced with replenishing the portfolio in a possibly disadvantageous interest-rate environment. Any capital gains distributed are taxable to the investor. A portion of the income may be taxable.

Investments in high-yield bonds (sometimes referred to as “junk bonds”) offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a junk bond issuer’s ability to make principal and interest payments.

Treasury bills are less volatile than longer-term fixed-income securities and are guaranteed as to timely payment of principal and interest by the U.S. Government.

Investments in structured products involve risk including, in the case of notes which are not 100% principal-protected, the risk of loss of principal. The return on a principal-protected note is linked to the performance of the underlying basket of securities and will depend on the performance of that asset. An investor in a principal-protected note may receive under certain conditions no more than the principal amount of the note, and will have taken the risk of the opportunity cost of not having invested in an asset which would have generated a positive return during that time.

International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments.

Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility.

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The credit quality ratings represent those of Moody’s Investors Service, Inc. (“Moody’s”) or Standard & Poor’s Corporation (“S&P”) credit ratings. The ratings represent their opinions as to the quality of the securities they rate. Ratings are relative and subjective and are not absolute standards of quality. The security’s credit quality does not eliminate risk. For information regarding the methodology used to calculate the ratings, please visit Moody’s at “www.moodys.com or S&P at www.standardandpoors.com.
Investment products:

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