PROTECTING YOUR SAVINGS IN A TIME OF RISING INTEREST RATES

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While federal retirees are generally protected from the ravages of inflation with the annual pension increase tied to the consumer price index, it is a lot more difficult to protect our personal savings. The returns on bank accounts and guaranteed investment certificates have been microscopic over recent years (not to mention the current yield on CSBs which is 0.65%).

While government and corporate bonds (and mutual funds that invest only in bonds) offer somewhat higher returns than bank accounts and GICs, they can also be subject to capital losses when interest rates rise. This is because there is an inverse relationship between the movement in interest rates and the value of a bond. When interest rates rise, bond prices decline...and vice versa. Here's how it works. In the simplest example, assume you own a perpetual bond (a bond that has no maturity date) paying 2% interest and the current interest rate is also 2%. In this case, you will earn $20 a year for each $1,000 invested and you could sell the bond at its $1,000 face value. But if interest rates were to increase to 4% you would earn $40 on any newly issued $1,000 bond. Therefore, a buyer would be willing to pay only $500 for your "old bond" since he/she would need to earn 4% when buying your old bond or would simply buy a newly issued bond (and, of course, it works the other way around if interest rates go down). The impact of changes in interest rates becomes less dramatic as the term to maturity of the bond shortens, and is zero when the bond reaches maturity since you will receive the face value when you redeem it. Thus, the price of short term bonds is less volatile than longer term bonds.

In order to keep a positive rate of return on personal investments as we come out of the "Great Recession", one should consider the potential benefits of accepting a slightly higher degree of risk, in line with our improved economy. Investment managers, recognizing the risks of holding fixed income securities in today's extremely low interest rate environment, have developed a number of strategies which offer much of the security of government bonds but with higher returns by investments in corporate bonds from both big and medium sized firms. In addition, while equities are subject to higher risks than fixed income securities, they also offer correspondingly higher potential returns. Therefore, some fund managers also include a component of blue-chip common and preferred stocks or other less risky equity-based investments in their portfolios. This combination of fixed income vehicles, along with some equities, can make for an investment with a steady income

from its interest and dividend component as well as the possibility of modest capital appreciation if the equities rise in value through economic growth and higher earnings.

If you are reviewing your financial situation and are unsure how to proceed, talk to a professional financial adviser. Everyone's situation is unique and there is a broad range of investment possibilities. With a financial adviser, you can review your personal objectives...including gaining a better understanding your time horizon and risk tolerance...and work out how best to achieve your goals. You can look at how your savings are working for you now, and what are some better ways to protect their value and increase your returns in what will likely be a coming period of rising interest rates.

Note: *The facts and opinions expressed in this article are those of the author, Robert Todd; they should not be understood to necessarily reflect the policy or opinion of the FSNA Ottawa Branch.*

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