How Will Bond Funds React to Rising Rates?

- COMPASS has been concerned with the risk of rising interest rates for some time due to the negative return potential of such an environment for bonds.
- We have structured client portfolios to be focused on short- and intermediate-term bond funds, high-yield bond funds, and funds that react favorably to higher interest rates (i.e., floating rate bond funds).
- Our goal is to take a defensive, lower risk posture with regard to interest rate risk to protect clients' principal.

It is difficult to predict how the markets will move once the Fed decides to raise rates. That said, this article explores some ideas about how different types of fixed-income mutual funds are likely to react to an increase in interest rates.

Debt securities and funds that invest in them have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities tend to be more sensitive to interest rate changes. Funds holding short-term debt securities are the least sensitive to changes in interest rates, while funds investing in longer-term bonds are the most interest-rate sensitive.

That being said, markets have responded very differently in past rounds of rate hikes. For example, during the rate hikes from March 2004 to June 2006, yields on the 30-year bond actually fell as the yield curve flattened; during the September 1993 to December 1994 hikes, yields rose across the yield curve. If the yield curve steepens (the long-end rises faster than the short-end) or shifts upward in a more or less parallel fashion, long-term bond funds could take a significant hit. But if the yield curve flattens, which is not out of the question given the troubles abroad that may continue to push investors toward the safe haven of U.S. Treasury bonds of all maturities, longer-term funds may fare better. For example, during the 2004–06 rate hikes, the 10-year Treasury bond lost 1.7% while the 30-year bond gained 2.2%.

Globally, it's expected that the eurozone and Japan (the two main non-U.S. developed markets for bond investors) will be relying on quantitative easing much longer than the United States, thus delaying their own rate hikes. But the market for high-quality non-U.S. government bonds, including German bunds and Japanese government bonds, can track U.S. Treasuries when investors seek safe-haven assets. If the Fed continues to delay the rate hike, it could be seen as a signal that it's concerned about economic growth and may stoke fears of slowing global growth, and German and Japanese government bonds could strengthen. Under the same scenario, the dollar is likely to weaken, which would boost issues denominated in euros or yen.

What does this mean for an investor's portfolio? Predicting the timing and magnitude of interest-rate movements is difficult, and many bond portfolio managers believe it's folly to significantly change a fund's position based on interest-rate predictions. Investors may be better off sticking with an allocation that suits their long-term investment goals, and understanding how different bond funds might perform during various rate environments can help.

The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should read the prospectus and consider this information carefully before investing or sending money.

Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest. With government bonds, the investor is a creditor of the government. With corporate bonds, an investor is a creditor of the corporation and the bond is subject to default risk. Corporate bonds are not guaranteed.

With international bonds, the investor is a creditor of a foreign government or corporation. International bonds are not guaranteed. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.