Federal Funds Rate Increase

What Should Investors Do Now That the Long-Awaited Increase in the Federal Funds Rate Finally Occurred?

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As Director of Asset Management for HBKS® Wealth Advisors (HBKS®), Brian Sommers oversees the firm's investment management processes for a distinguished group of nearly 30 investment advisory representatives. Mr. Sommers chairs the Investment Policy Committee of the firm and is instrumental in the identification, evaluation and recommendation of the investments that make up HBK's portfolios. He brings HBKS clients the expertise of more than 20 years managing a wide range of portfolios for both high net worth individuals and institutional clients.

Over his career, Mr. Sommers has managed an impressive array of investments, including Taft-Hartley plans and endowments, and plans for foundations, corporations, individuals and public entities. He has held positions in investment consulting and client service for both institutional and high net worth clients.

On December 16 the U.S. Federal Reserve announced a 0.25% increase in the federal funds rate. This rate had been kept near zero for almost seven years in an effort to give economic activity in the United States a much needed boost. That policy kept borrowing costs low, but the Federal Reserve Board now believes the economy is healthy enough that interest rates can be lifted in order to keep inflation from becoming a problem in the future.

In its statement following the move, the Federal Reserve Open Market Committee said the U.S. economy continues to expand and the U.S. job market continues to improve. Further, the committee said it expects "economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

The U.S. Central Bank realizes that weak economic growth in most countries around the world will likely cause lackluster demand for U.S. goods and services abroad. Consumers and businesses need to be reassured that rates will not rise substantially for a while in order to keep the domestic recovery alive. The Fed hopes that by raising rates in a very slow and gradual manner inflation will remain low and the economic recovery won't be choked off.

At the same time, central banks in Europe, Japan and China are expected to continue lowering interest rates to help bolster their sluggish economies. The divergent policies between these countries and the U.S. should translate into money continuing to flow into longer-term U.S. treasuries thanks to continued strength in the U.S. dollar. This demand for longer-term U.S. treasuries could help to keep longer-term rates from rising too much, which might cause short-term rates in the U.S. to rise more than long-term rates.

If short-term rates rise more than long-term rates, then long-term bonds will fall less relative to short-term bonds. So while investors might be tempted to move a significant portion of their assets, especially their fixed-income assets, into cash or very short-term bonds, such a move may not work out as hoped. We believe there are better strategies to manage interest rate risks.

How HBKS manages risk in our clients' portfolios.

The primary way we manage risk in our clients' portfolios is by diversification. Through diversification an investor is exposed to many asset classes that may behave much differently from each other during a period of rising interest rates. Also, HBKS uses active managers because they have the ability to make tactical changes to their portfolio to mitigate risks, including the potential for rising interest rates.

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The following is an assessment of how each of the asset classes that may be held in the HBKS client portfolios might react to rising interest rates, and how the active management of these asset classes can help to lessen the risks associated with rising interest rates:

Core bonds

Bond prices tend to fall as interest rates rise. However, for all but the most aggressive investors, core fixed income investments remain one of the best providers of protection against a potential downturn in global stock markets. This was demonstrated in the stock market turbulence earlier this year, when bonds were one of the few asset classes to post positive returns when global stocks were in a short-term downtrend. As a result, core bonds will continue to have an important role in diversified portfolios as a means to generate income, even if interest rates rise.

It is important to point out that rising rates do not necessarily mean negative total returns for core bonds. A bond's total return is comprised of the bond's price change plus the interest income it generates. As rates rise, the income on a bond can help offset falling prices. A sharp increase in rates over a short period of time may result in negative fixed income total returns. However, if the rise in rates is slow and gradual, as the Fed stated it would be, losses on core bonds will be minimal, and it is possible the interest income will sufficiently offset the price decline to produce positive total returns.

There are many complicated factors involved in managing a bond portfolio. Thankfully, most core bond managers are now given far more flexibility in managing the durations and credit exposure within their holdings than ever before. As a result, they have at their disposal more tools to manage through a rising interest rate environment. Though core bond portfolios remain highly correlated to the aggregate bond market, these additional tools should help mitigate some of the effect of rising rates.

Foreign bonds

Corporate and government bonds of foreign developed- and emerging-market countries provide exposure to fixed-income vehicles that may have a much different yield and credit profile than U.S. bonds. These investments do not necessarily move in tandem U.S. bonds, so investments in foreign bonds provide diversification and can enhance the yield of a fixed-income portfolio. It is important to keep in mind, however, that these bonds are subject to the same types of risks as a domestic bond, and there are additional risks, such as currency risk if the fluctuations in currency are not hedged.

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Non-traditional fixed income

HBKS also attempts to reduce the impact of a rise in domestic interest rates by diversifying the fixed income portion of our clients' portfolios into non-traditional fixed income strategies that provide income while potentially helping to protect the portfolio from certain risks. One type of non-traditional strategy is unconstrained bond funds, which seek positive returns regardless of market conditions by investing both long and short in fixed-income securities. HBKS also uses floating-rate bond funds, which are funds that invest in bonds and debt instruments whose coupons fluctuate in line with the underlying level of interest rates. Floating-rate bond funds typically display significantly higher volatility than core fixed income holdings and are highly correlated to high-yield bonds but are a bit safer because the debt instruments held are typically senior to the high-yield debt on the company's capital structure.

Domestic stocks

It has been widely debated for the past several years what effect a rising interest rate environment will have on domestic stocks. Many believe that higher borrowing costs will cause profit margins to contract, leading to a stock market correction.

However, according to a report by Russell Investments, in the last 45 years, U.S. equities tend to rise when interest rates are rising, although by less than when rates are falling. Russell found that, on average, domestic stocks rose 9.7% in time periods when rates are rising versus 10.7% in time periods when rates are falling. In addition, when looking at rising interest-rate time periods, Russell found that U.S. equities tend to perform better when rates are rising slowly. However, these results should be tempered because U.S. equity valuations are higher than their historical average, and stock market returns tend to be less than average the years following time periods when valuations are higher than average.

Foreign stocks

Diversified exposure to foreign developed and emerging market stocks has the potential to provide an additional source of growth during periods of rising interest rates in the U.S. In the same study cited above, Russell Investments found that during the past 45 years, foreign stocks usually outperform domestic stocks when the Federal Reserve is raising rates. During this time, there were 11 periods of rising interest rates in the United States. U.S. Equities underperformed non-U.S. equities in 9 of these 11 time periods.

Alternatives

Alternative investments provide returns that are not correlated to stocks or bonds. Alternatives also can deliver long-term diversification benefits and may prove to be less sensitive to rising interest rates. Some of the types of alternatives we utilize are hedged equity (funds that utilize both long and short investments in equity securities in order to obtain a return profile that is not highly correlated to the broad stock market indices), global macro (funds that tactically allocate between stocks, bonds, commodities and cash based on the relative attractiveness of each asset class, usually based on a proprietary model) and liquid real assets (investments in physical or tangible assets that have value due to their substance and properties. Real assets include precious metals, commodities, real estate, agricultural land and oil).

Through the use of alternative investments, non-traditional fixed income investments, active managers who have flexibility, and by making tactical asset allocation changes to the long term strategic allocation, HBKS believes that our clients' portfolios are well-positioned for a rising interest rate environment.

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