Retirement Investors Should Plan for Rising Interest Rates

Equities would benefit in the short term, while fixed income investments would decrease in value.

By Lee Barney **EDITORS@PLANSPONSOR.COM** | September 03, 2015

Asset managers and retirement plan advisers say they do not expect the Federal Reserve to raise the Federal Funds Rate from its current 25 basis points and that the uncertainty over when the Fed will raise rates will lead to continued volatility in both the fixed income and equities markets.

However, if the Fed were to raise rates, it would benefit equities in the short term, while fixed income investments would decrease in value.

“The concept of interest rates going up dramatically is not in the cards,” says Bob Andres, chief investment officer of Andres Capital Management in Berwyn, Pennsylvania. “People have been dealing with low rates for a long period of time, and, unfortunately, that will continue for a lot longer than people think. We are not going to see a 10-year Treasury go to a 4% to 5% interest rate because we do not have a strong economy or inflationary pressures.”

The Federal Reserve would like to raise rates to begin the normalization process of bringing fixed income and equities back into their historical sync—since equities are currently overvalued—as well as to have the ability to lower interest rates should the economy deteriorate further, but in this sluggish environment with the U.S. GDP in the 2.3% to 2.6% range, it won’t, Andres says. “That is why you have heard the Fed talk about raising rates for so long and they haven’t done it,” he notes.

Just like last year when the stock markets fell in December and the Federal Reserve held off on raising rates, the current stock market declines will keep the Fed at bay, agrees Jason Brady, head of fixed income investing at Thornburg Investment Management in Santa Fe, New Mexico.

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"We have been expecting the Fed to raise rates for the past six years, but they won't because global growth isn't that great and U.S. inflation is low," Brady says. "At most, the Fed will raise rates by 25 to 50 basis points."

The Fed also is leery of strengthening the dollar, says Mike Chadwick, president of Chadwick Financial Advisers in Unionville, Connecticut. "We have to think about the global currency war," Chadwick says. "Most countries are trying to devalue their currencies to be more competitive. If we were to raise rates, the dollar will become a lot stronger and we will become less competitive."

The uncertainty over when the Fed will raise rates is fueling the volatility in the markets, says James Macey, senior vice president and portfolio manager at Franklin Templeton Solutions in New York City. "Uncertainty is the worst possible thing for the markets," Macey says. "The uncertainty over the timing of a September or later rate rise is paralyzing the market right now."

However, if the Fed were to raise rates, based on history, it will benefit equity investors, Macey says. "Equities do well in rising rate environments," he says. "If you were to look at tightening cycles since 1955, where there have been at least three consecutive rate increases, on average, the S&P 500 rose 6% in the 12 month period following the first tightening."

A Fed tightening will increase stock market volatility "but not erode stock market performance," agrees Rich Saperstein, chief executive officer of HighTower Treasury Partners in New York City. "It would signal to the markets that the Fed is confident in the growth of the U.S. economy and corporate earnings."

If rates rise, this will create an opportunity for investors to buy equities, says Chad Carmichael, principal and practice lead of U.S. retirement at North Highland in Charlotte, North Carolina. He is of the opinion that the Fed might increase rates. "We are seeing consumer consumption, lending rates and job creation pick up—all pointing to a strong U.S. economy and consumer, which are good for investors," Carmichael says. "Retirement plan participants should be using volatility as points of inflection for their asset allocation, making sure they are appropriately allocated and maximizing their contributions."

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For fixed income investors, “rising rates would have a really big impact,” Chadwick says. “Fixed income investments have an inverse relationship to interest rates. Typically, when interest rates go up, the value of fixed income investments go down. Not all bonds are safe today. A lot are overpriced by as much as 15% to 30%.”

In this environment of flat interest rates and the anticipation of a rise in interest rates, HighTower Treasury Partners expects continued volatility. “Obviously we are in an environment where it appears that at some point, the Fed will raise interest rates,” says Steve Bogner, managing director at HighTower in New York City. “As a trusted adviser to retirement plans, two years ago, we started suggesting to our retirement committees that they move out of longer duration fixed income and inflation-protected funds to mitigate some of the potential risk of a rising rate environment.”

In addition, HighTower has “gone out in front of the volatility that could occur in the bond market by advising plans not to offer risky bond funds,” Saperstein adds.

Brady says rising rates would benefit retirement plan participants and retirees, particularly with respect to their fixed income holdings. “While a lot of people who own fixed income assets might look at rising rates as a negative, for participants and retirees, rates going up is a good thing because it creates a lot more income in the marketplace,” Brady says. “In the late 1990s, 10-year Treasuries delivered 4% after inflation, and you could build a solid portfolio around that. Today, the 10-year Treasury is in the 25 basis-point to 50-basis point range. If we can get yield to rise to 3%, with inflation at 1.5%, that gives you in very broad terms a net 1.5% yield, which is quite a change and would be beneficial for retirement investors.”

“In a rising interest rate environment, not all bonds react the same,” Macey says. “Leveraged loans rise in value once LIBOR and other short-term rates increase. We are taking a global approach to managing our fixed income investments. Diversification and active management are very important with respect to fixed income investments, as well as equities, in a rising rate environment.”

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