Prepare for rising interest-rate environment

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After six years of holding interest rates at record low levels, the Fed recently announced the end of its quantitative easing program. As economic data regarding employment and inflation continue to show signs of growing strength, the Fed is soon likely to remove its "considerable time" language about the length of time it expects to keep rates low from its forward guidance.

As arbitrary as it may seem, the simple removal of this phrase from future Fed guidance is likely to be interpreted by the markets as the signal for the beginning of the end of ultra-low interest rates.

During the past 33 years of generally falling interest rates, we have enjoyed unusually strong returns from bond funds. Again this year, despite nearly universal predictions to the contrary, one of the top-performing fund categories, with a year-to-date total return of 18 percent, is long-term bonds.

At the risk of being labeled just another "boy who cried wolf," I believe it is time to begin adjusting your investment strategy in anticipation of a rising interest-rate environment. While some believe the Fed's economic outlook to be too optimistic, it is forecasting that three years from now short-term rates will be over 3 percent.

How you prepare for rising rates should depend on where you are relative to your retirement date.

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Retirees — Rising rates will be cheered by most retirees and those close to retirement. Higher interest rates will make it easier to generate income in retirement and put less of your accumulated retirement savings at risk.

As short-term rates rise, consider liquidating intermediate- and longer-term bond funds and in their place purchasing shorter-term bond funds. Fortunately, for assets held in 401(k) and 403(b) plans, most offer vehicles that are called stable value or fixed rate funds. These funds are ideal for your conservative assets in a rising interest-rate environment because they currently generate a much higher yield than that of a money-market fund with extremely high safety of principal and little or no interest rate risk.

Downshifters (15 years or less from retirement) — While news that rates will be rising is likely to lead to a short-term sell-off in stocks, the good news is that rising rates have traditionally been beneficial for stock portfolios at a very critical time for your savings. The key is not to panic in the face of any short-term pullback and as stock prices invariably rise, periodically harvest gains by gradually taking equity risk off the table and shifting some of your assets to bonds.

Ideally, the "downshifter" wants their bonds to earn T-bills + inflation. To accomplish this you should focus on stable value, TIPS (Treasury Inflation Protected Security), and money-market funds while rates are rising. For those willing to take additional risk in exchange for higher expected returns, consider adding a small (10-20 percent) exposure to higher yielding bond funds.

Young Turks (15 years or longer to retirement) — First and foremost you need to make sure you are saving at least the amount required to maximize all company matching contributions. Focus your investments on long-term growth and recognize that while the U.S. is likely to soon start raising its interest rates, much of the rest of the world is likely to be cutting theirs.

This is good news for you. To maximize your investment gains, invest globally and keep a systematic rebalancing policy in place (yearly at most). Given the forecast for rising rates in this country, avoid interest rate sensitive sectors such as funds that invest primarily in Utilities or Real Estate Investment Trusts. You are also likely to see inflation during your investment time horizon. Historically, "real assets" such as actual real estate (not REITs), or a broad basket of commodities, have outperformed financial assets during such times.

While these recommendations vary somewhat based on your proximity to retirement, they can be summarized as follows:

1) Reduce your exposure to intermediate- and longer-term bond funds;

2) Increase your exposure to your plan's stable value or fixed rate fund;

3) Don't bail out of stocks because historically they've performed well when rates begin to rise;

4) Globalize your portfolio and reduce or eliminate your exposure to interest rate sensitive sectors like Utility and REIT funds;

5) Consider adding inflation-sensitive funds to your portfolio.

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