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How to Invest in Bonds *in a* Rising Interest Rate Environment

Some investors out there don't want to invest in Bonds or GICs because they read forecasts that interest rates are increasing. They want to wait for higher rates before they invest. On the surface, this sounds quite reasonable. This may not be the best approach, however.

If you are reading in the news that interest rates are expected to rise, it usually means the anticipated increases have already been priced into the bond market. Waiting for interest rate increases is usually only beneficial when unanticipated increases occur.

For example, let's say bond rates are as follows: one year, 2.25 percent; two year, 2.75 percent; three year, 3.25 percent; and four year, 3.75 percent.

If you invested your \$1000 in a one-year bond, after a year's time you would have made \$22.50 and received your \$1000 back.

Now let's say you invested in four year bonds and interest rates increased by 0.5 percent across all maturities. You would have been paid \$37.50 and your bond would still be worth \$1000 because your four-year bond is now a three-year bond at the same 3.75 percent interest rate.

If rates continued to rise by 0.5 percent annually until maturity and you continued to invest in one year bonds because rates were still rising, you would have made \$30 less over the four-year period.

An Alternative Laddered Bond Portfolios

One way for long-term bond investors to effectively invest in a changing interest rate environment is to set up a laddered bond portfolio and hold all their bonds to maturity. Essentially, you own bonds that mature each year over a period of time, such as 10 years.

Keep in mind a laddering strategy may not be suitable for investors who need ready access to their cash.

The benefit of investing your bond portfolio in this manner is that you are exposed to returns across all maturities; you do not have to predict where interest rates are going. This strategy is quite effective because even in a rising-rate environment, you will always have some money maturing within a year that can be reinvested into the expected higher rates.

There is still some strategy involved in this passive investing approach in that investors may want to consider the length of the bond ladder, particularly in our current environment where interest rates are rising; it may be prudent to shorten the

ladder, such as purchasing bonds that are five years or less in maturity.

It is not uncommon to shorten or lengthen the bond ladder to take advantage of the trend in rates. Keep in mind a laddering strategy may not be suitable for investors who need ready access to their cash. ▲

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