CARLSON
FINANCIAL
MANAGEMENT

INTEREST RATES AND INCOME PORTFOLIOS

When interest rates go up bond prices go down. At first this doesn't seem to make sense. It is the opposite of what happens with stocks; if dividends go up then generally the price does too.

A simple illustration ought to clear it up. Let's say we buy a bond for $1,000 and it pays 5%, $50 per year. Next year interest rates go up to 6%. If I want $50 annually in interest income, how much should I pay? 6% of $833.33 will get me $50. The higher the interest rate the less we need to pay to receive a given amount of income. The other side of it, of course, is that if we already own the bond then any potential buyer is going to pay us less than we paid for it. This is an illustration of a <u>fixed</u> income security, a bond is going to pay the same stated interest amount no matter what.

A bond fund has an advantage in that it can take the principal from bonds as they mature and re-invest in new bonds at the higher interest rate. The faster bonds mature, the more quickly the fund will be able to profit from the better rates. Even so, the pressure from bonds already held is going to push the fund price down.

Other income securities are subject to the same kind of interest rate pressure. REIT's (real estate investment trusts) and MLP's (master limited partnerships which generally invest in things that will provide a steady stream of rent or royalty, like an oil pipeline) are designed to provide income but do so with the hope that it will rise at least enough to keep up with inflation. Still, interest rates may outrun the increase in rents. As an example-say we pay $1,000 for a REIT share that pays a $40 dividend when interest rates in general are around 4%. Then the dividend goes to $50 but interest rates go to 6%. All other things being equal the value of the REIT share will fall. An investor with $1,000 will prefer the $60 he gets from a bond to the $50 he gets from the REIT.

When interest rates fall exactly the opposite occurs. The value of income securities goes up. A $1,000 bond paying 6% ($60) is worth $1,200 when interest rates fall to 5% because 5% of $1,200 is $60. The best of all possible worlds for an income investor is to hold a portfolio of REIT's and MLP's when interest rates are falling. She gets the rise in income at the same time the value of the principal is going up.

When interest rates are rising the income investor faces a bittersweet scenario. If the portfolio is properly diversified then income will go up, but principal will fall. The monthly statement may be received with some trepidation: the good news is this month's income went to $5,500, up from last month's $5,000, the bad news is the portfolio's value fell from $1,000,000 to $990,000. A $1,000,000 portfolio that produces $50,000 per year can become an $800,000 portfolio producing $80,000 annually.

This is not a theoretical disquisition. Most investors are in fact thinking mainly of retirement or are already there. When they do begin retirement withdrawals they face a tough choice, one that is more emotional than rational. Some can accept the trade-off of less principal for more income; and there is some consolation in knowing that interest rates go both up and down. Unlike with stocks, which we can at least expect to go up continually over time, an income portfolio may fluctuate permanently within a range.

For those who cannot passively accept falling principal there are two choices: dividend paying stocks or a growth portfolio. Stocks with reasonable dividends are less likely to fall in value and will probably be able to keep up with inflation. But they usually pay much less than other income securities.

Some form of growth portfolio is generally what we all have before retirement. We don't need income, so we hope for growth. Retirement does not necessarily have to change that. If an "income portfolio" is not an option and if conservative stocks don't pay enough then an investor can continue to take the greater risk of growth stocks. Income in such a portfolio is not dividends and interest, but capital gain.