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How Rising Interest Rates Affect Your Income Portfolio

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It has been quite a ride in both the stock and bond markets as the Federal Reserve reiterated its zero interest rate policy and bond buying programs through mid-2014. This announcement and subsequent Q&A session with Fed Chairman Ben Bernanke sent stocks, bonds, and commodities downward as investors reacted to the fears of rising interest rates. In fact, there was virtually nowhere to hide for income investors as just about every yield producing asset class was bathed in red ink and the 10-Year Treasury Yield Index ($TNX) spiked to new year-to-date highs of 2.4% on Thursday.

Investors that had been used to conservative returns and low volatility are starting to get nervous about the prospects for their income generating assets moving forward. That data is confirmed by asset flows from Index Universe which list the iShares TIPS Bond Fund (TIP), iShares Investment Grade Bond Fund (LQD), SPDR Barclays High Yield Bond Fund (JNK), and iShares High Yield Bond Fund (HYG) as four of their top 10 ETFs for asset redemptions in 2013. Combined, these ETFs have lost nearly $12 billion from investor redemptions. This is due in large part to the interest rate sensitivity of the underlying bonds in these funds, which have come under heavy selling pressure.

In prior years, these ETFs have been some of the top performing asset classes for income seekers along with high yield dividend paying sectors such as the iShares U.S. Preferred Stock ETF (PFF) and iShares Mortgage REIT Capped ETF (REM). In today's reality, investors are having to stretch more and more to earn the type of yield that they have been accustomed to in order to maintain their lifestyle and income needs. However, the last six weeks have sent these high yield asset classes stumbling and reasserted the adage that high yield = high risk.

Conversely the same fund flow data confirms that bond ETFs with lower average durations and less sensitivity to interest rates have gained assets. The PowerShares Senior Loan Portfolio (BKLN) and Vanguard Short Term Bond ETF (BSV) are in the top five ETFs for new assets in 2013 with new additions of $3 billion each. Fixed-income investors have clearly been lured to floating rate securities due to their low duration and adjustable coupon rate which makes them less susceptible to interest rate volatility. However the key trade off with senior loans is that you are swapping interest rate risk for credit risk, as most loans are rated below investment grade.

The key to success with income investing over the next six months will be to keep your expectations for returns in line with the current volatility. It is important to remember that we have undergone a tremendous price correction in bonds in a very short period of time, which is why I would not be surprised to see at least a temporary relief rally emerge.

Those that have been shortening the duration of their portfolios and have cash available will have sidestepped a great deal of this jump in interest rates. However, it is just as important to be vigilant for new opportunities in both bonds and equity income funds that provide solid dividend streams. By using this volatility to your advantage you can establish new positions in quality holdings that have been oversold.

Editor's Note: I own HYG in my own account.

To get more investor insights from Fabian Capital, visit their blog here or click here to download their latest special report, The Strategic Approach to Income Investing.

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