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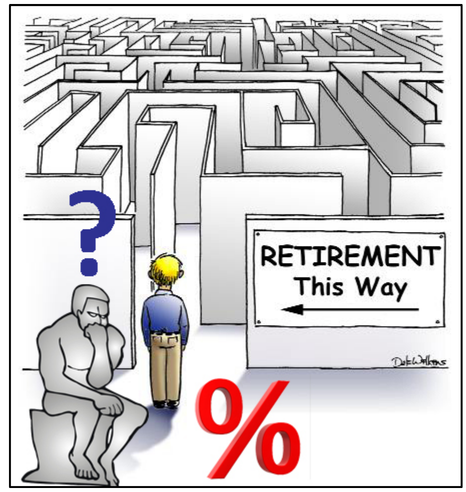
Interest rates have you worried? They should

"The four most dangerous words in investing are: 'This time it's different.'"

– Sir John Templeton, investor and philanthropist (1912 - 2008)

Navigating the Retirement Maze



Much as I hate to disagree with Sir John, who made fortunes in both the depression of the 1930s (buying stocks) and the stock bubble of the late 1990s (shorting stocks), in the world of interest rates it really has been different lately. Never before have we seen a time in which $14 trillion in bonds carry negative yields, and stock markets that seem to defy earnings gravity. Yet the laws of financial gravity have not been repealed, and there is an explanation for where we are and some thoughts on where we're headed. The timing? That's another issue entirely, but it's better to be prepared for change than to let it catch you unawares.

How we got here

The real estate crash of 2008-09, resulting from a combination of relaxed borrowing constraints and a push by Wall Street firms to securitize junk mortgages disguised as high quality bonds. It created a massive global liquidity crisis, as institutions and companies stopped loaning to one another for fear not being repaid. The same crisis also cratered the world stock markets, as most anything was for sale in an effort to raise cash.

To alleviate this, the world's central banks, particularly the US Federal Reserve, created massive amounts of liquidity (cash), and guaranteed bank credit lines in order to get loans flowing again. Once the immediate crisis was past, the Fed felt that the economy needed a stimulus, and so lowered the overnight borrowing rate – the only rate over which the Fed has direct control – to practically zero, and has held it there for six years, save for a small increase last year. The Fed also purchased bonds as a means of lowering their yields, with the idea that decreasing borrowing costs would stimulate the economy. It is questionable whether these had the desired effect of increasing economic growth. They have, however, had some significant side effects, good or bad depending upon which side of debt you happen to be positioned.

Consequences

From the simplest perspective, low interest rates favor borrowers over creditors. Consequently, low rates have the effect of pushing asset prices – housing, stocks, companies, collectibles – higher. Stock markets have moved higher, and the domestic housing market recovered from its post-crash lows.

Lenders, on the other hand, haven't been quite as fortunate. Pension funds and insurance companies that depend upon bonds to generate sufficient income to pay off their liabilities – pensions, annuities, policies, etc. – have struggled to meet their financial obligations. While there have been few bankruptcies to date, a prolonged period of near-zero rates may ultimately cause many of these institutions to default on their obligations, and the various government funds set up for this eventuality may be insufficient to cover the potential losses.

From the perspective of the individual investor, the consequences have been two-fold: stock prices increasing, and debt instruments – bonds, CDs, annuities – generating much less income than they did eight years ago. The

info@CoromandelWM.com Phone: 781.728.9001

former seems like a good thing, except when you realize that current market prices are dependent upon continued low interest rates. The latter is particularly painful for retirees who assumed that flipping bank CDs was going to provide them with sufficient income. As a consequence, there has been a "stretch for yield," entailing taking on greater risks to get the yield that they feel they need. It has led to increased investment in high yield ("junk") bonds, as well as dividend-producing stocks and various income-producing mutual funds that the buyers don't fully understand. I can almost hear the robot in "Lost in Space" shouting: "Danger, Will Robinson!"

What we can expect

I can make a few predictions here. Interest rates will eventually rise. I can't tell you when, or by how much, except that they will most likely increase very slowly. But any increase in interest rates will, by necessity, be accompanies by losses for current bond holders – when rates go up, bond prices go down – and stock markets will take a hit as investors start to shift to higher yielding bonds. Equity markets are currently trading at significantly higher levels than corporate earnings can justify. Using the Shiller CAPE 10 ratio, one of my favorites, we are in the top 5 percent of historic price-earnings ratios. Without low interest rates, the market ratio would most likely be much lower right now. Plus, we're overdue for a market correction.

What you should do

One of the most dangerous behavioral tendencies is known as Recency Bias, assuming that the future will resemble the near past. Combine that with Confirmation Bias (listening to only that information that confirms our current beliefs) and Herd Mentality (doing what most everyone else is doing), and you have a recipe for disaster when markets shift suddenly. Want to play it safe rather than sorry? Here is what I recommend:

- Review your existing portfolio, and particularly pay attention to assets that you might need to sell in the next five years. What level of "rate risk" are you currently taking?
- Consider your tolerance for risk. Did you sell out at the market bottom in 2009? If so, maybe now would be a good time to start lowering the overall risk level of your holdings.
- Check the duration of your bond funds. The higher the duration, the greater the likelihood of losses when rates increase. High yield bonds are particularly susceptible to economic downturns.
- Increase your cash allocation. It won't earn much, but can give you some peace of mind as well as some "dry powder" for buying stocks and bonds once prices have fallen.

At the risk of sounding trite, something significant is going to occur in the stock and bond markets at some point in time. Make sure that your portfolio matches your investment time frame and your tolerance for market volatility, and you'll be in significantly better shape than the rest of the "herd."

George Gagliardi is a financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. *This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.*