Leigh Baldwin & Co.

Investment Brokerage

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Spend 3 minutes to learn:

HOW TO PROFIT FROM HIGHER INTEREST RATES

"How can you call me unemotional? You've seen me cry over interest rates!"

Leigh Baldwin & Co. Investment Brokerage Newsletter

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How to Profit From Rising Interest Rates

ATTENTION, INVESTORS: THE DAYS OF ROCK-BOTTOM INTEREST RATES ARE OVER.

When Fed Chairman Alan Greenspan announced on June 30, 2004 that the Federal Reserve Board was raising interest rates for the first time in four years, he heralded what many expect to be a series of "measured" rate increases.

The hike is also the beginning of the end of a 46-year low in interest rates. Historically, interest rates have been falling since the 1980 high of 20 percent, a time when 30-year U.S. Treasuries (remember?) yielded 15 percent.

Although this rate applies only to overnight loans between banks, it has a ripple effect on all short and long-term interest rates throughout the economy.

How Interest Rates Affect Your Portfolio

Managing your portfolio through a period of rising interest rates poses challenges…and opportunities.

When interest rates rise, the price of existing bonds falls. That is because investors can obtain higher rates on newly-issued bonds. As a result, the price of old bonds must fall to make them competitive with new bonds.

Bond rates are determined by the market, not by the government. Consequently, bond rates often move in advance of the federal funds rate, as investors try to anticipate the direction of interest rates.

To protect your bond portfolio when rates are rising, consider:

Shortening Maturities

As interest rates rise, long-term bonds lose more value than short-term bonds. Furthermore, bonds with low coupon rates will suffer a bit more than similar bonds with higher coupon rates.

At current low rates, investors may not be properly compensated in a 30-year security. Most experts agree that investors who are buying bonds or bond funds today should choose shorter maturities.

In a rising interest rate environment, as shorter term coupon bonds mature, investors can increase their income stream with higher yielding coupons. This is particularly refreshing after 5 years of lower interest rates.

Protecting Your Bond Portfolio With a Ladder

Diversification is as important in bond investing as it is in stock investing. A savvy approach to bond investing is to spread your risk over a series of different maturities. Set up a ladder—in essence, a series of bonds with a range of maturities.

Here is how it works. If you were to buy equal amounts of Treasury or corporate bonds due to mature in one year, three years, five years. seven years and nine years, that portfolio would have an average maturity of five years. The next year, when the first bonds mature, you would reset the ladder by allocating the money into a new 10-year bond. Your portfolio would then have an average maturity of 6 years.

Two years later, when the 3-year bonds mature, you would buy more 10-year bonds. You would continue to add to the ladder whenever a bond matures, which always maintains the average maturity in the five to six-year range.

The advantage is that you do not have to worry about interest rates, especially if the ladder that you

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construct has bonds coming due every few years. If rates rise soon after you have bought this year's bonds, you can take comfort in the fact that soon you will have money coming available to take advantage of the change. The beauty of laddering is that if rates happen to decline after you buy, you have managed to secure the higher rate for that portion of your portfolio. Either way, you are improving your bottom line.

Using Alternative Investments

As an additional measure of protection, you may wish to consider convertible securities and inflation-indexed securities.

Convertible Securities

Seasoned investors are becoming more aware of the importance of supplementing their income with equity-oriented investments to help outpace the effects of inflation. Convertible securities offer the potential advantages of debt and equity securities. Convertibles combine attractive yields of traditional, fixed-income securities with the capital-appreciation potential of common stocks.

Convertibles have historically provided higher returns than bonds, with minimal additional risk. In addition, they are typically less susceptible to rising interest rates, due to their conversion into stock feature. Convertible securities may also offer upside potential when the underlying stock is increasing in value. Conversely, convertibles offer downside protection if the stock experiences a decline. Generally, convertibles capture 60% to 70% of the underlying equity's upside gain, while assuming only 30% to 50% of the downside.

Inflation-Indexed Securities

To further protect your portfolio, consider inflation-indexed securities. Currently, inflation is not a pressing problem. However, as the economy improves, consumer prices will resume their rise.

Investors who are planning for retirement or are looking for extra income gravitate toward **Treasury Inflation-Protection Securities** (TIPS) because of their safety and dependable payout. TIPS keep pace with inflation because their value is adjusted upward in step with rising consumer prices.

If consumer prices fall, you are still safe. The government guarantees that your original investment will stay the same. In exchange for the safety net, Treasury Inflation-Protection Securities pay a lower interest rates than Treasury securities of similar maturities that do not have the adjustment feature.

Cautionary Advice

It should be noted that these investments still carry risk. Individual TIPS are not easy to trade on the open market. Secondly, if sold before maturity, you may receive more or less than your original purchase price. Finally, you are liable for the tax on the interest income and on the inflation adjustment (even though it is not a cash payout). For these reasons, it is best to hold TIPS in a tax-deferred or nontaxable account, such as an IRA.

Consider Higher Quality Stocks

Higher interest rates do not necessarily mean that the stock market cannot do well. However, investors should take a closer look at the quality of the stocks in their portfolios. Most experts agree that choosing quality stocks is critical when interest rates are rising. Companies with steady earnings, solid profit margins and reliable revenue streams tend to perform best. And while companies with increasing dividends are always attractive, they are especially appealing during a rising interest rate environment.

The list of uncertainties weighing on the market seems to be increasing every day. There is chaos in Iraq, unease surrounding the U.S. Presidential election and continuing terrorist attacks around the world. In addition, there are also skyrocketing fuel prices and rising inflation.

Obviously, there is not much investors can do about geopolitics. However, there are steps that they can take to protect their portfolios from rising interest rates and budding inflation. The trick is knowing which steps to take, depending on personal considerations. Clearly, people nearing retirement should act more cautiously than younger investors in their 30's whose longer investment horizons allow them to take more risk. But there are some general rules for investing in a rising-interest-rate environment that apply almost universally.

Defensive areas such as pharmaceuticals, healthcare, tobacco, food, beverages and consumer staples tend to do well during a rising-interest-rate environment. Why? No matter what is happening with interest rates, people continue to need medicine, food, beverages, healthcare and everyday staples. And these producers tend to have sufficient pricing power to keep profits intact despite rising costs. Commodity-based sectors such as chemicals, natural resources, energy and metals also thrive as costs for raw materials increase.

In contrast, companies that are interest-rate sensitive, such as banks, real estate investment trusts, home builders, utilities and new technology companies (which often rely heavily on borrowing), typically underperform when rates rise.

Call Today!

Depending on your investment objectives, these and other strategies may be able to help you to effectively navigate during a rising-interest-rate environment. If you have questions about your investment portfolio or if you would like to implement strategies to protect your assets from higher interest rates, please call your ***Leigh Baldwin & Company*** investment advisor.

Managing Your Money

Effective Tax Planning Tips:

Specific Strategies That Can Save Your a Bundle

One of the most effective ways to shift income or losses from one year to another is through investments. As the market value of your investments fluctuates, so does your personal wealth. However, market gains or declines have no effect on your transactions until you sell the investment. By timing transactions properly, you can reap the maximum tax benefit from your investments. When planning your tax strategy, consider the following:

Do not let the tax tail wag the investment dog

The cardinal rule for investing is to allow the basic validity of the investment to be the deciding factor in whether to acquire, hold, or sell it. Thus, tax considerations should always play a secondary role in your decision. But once a decision has been reached, the manner of implementation frequently can affect your profit (or loss).

Give the IRS its due

Do not cut off your nose to spite Uncle Sam's face. Many investors who have enjoyed substantial capital appreciation on well-chosen securities are reluctant to realize these profits due to the capital gains taxes involved. That can be a costly mistake. If good judgement dictates that the time has come to unload, then the investment should be sold. A large profit—even one in which the IRS shares—is better than a smaller profit later. (The IRS would share in that profit as well.) When it is time to sell, sell—and give the IRS its due.

Important date to remember

Under the current tax code, the trade execution date is defined as the true date of sale for security transactions. To qualify for gains and losses in the 2004 tax calendar year, stocks must be sold on or before December 31, 2004.

Selling part of a position

When shares of a particular stock have been purchased at varying costs, an investor may gain a tax advantage by selling a portion of those shares. The IRS assumes a FIFO inventory method (first in, first out), but the investor may elect the LIFO inventory method (last in, first out) instead.

Additionally, an investor can sell "identified shares" by: (a) delivering those certificates or (b) by instructing ***Leigh Baldwin & Company*** to deliver shares if they are held in street name.

Worthless securities

If a security becomes worthless during the tax year, that loss can be considered a deduction on the last day of the year. Arrange to have your brokerage firm verify in writing that the worthless security is no longer trading and/or has lost its market value.

"Wash sales"

Many investors play losses against gains by selling a losing position and then buying it back. Thus, they are able to establish a loss but still own what they believe is a sound long-term investment. This is permissible, as long as the 30-day repurchase limitation (wash sale) rule is observed. That rule prohibits you from claiming a loss on any security that you have replaced with a substantially identical security or option within 30 calendar days before or after selling your original holding. The wash sale rule relates only to losses; repurchasing immediately before or after establishing a gain is permissible.

> ***"The wash rule applies even though the maneuver spills over from one tax year to another."***

This has useful implications, for it means that with proper forethought, you can establish a loss toward the end of one year or delay taking it until the start of the next. Implementation of this strategy should depend upon how it can achieve the maximum tax advantage for you.

One way of avoiding the wash sale rule is to sell the securities (to establish the loss) and then to buy a similar position in a another company within the same industry. Therefore, you have been able to maintain an equivalent position in that industry. ■