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Retirement Report
LITTLETON PUBLIC SCHOOLS
403(B) AND 457 RETIREMENT PLANS

Understanding Changes in Interest Rates and the Impact on Bonds

Recent financial news reports have been focused on concerns about rising interest rates and the potential impact on the bond (fixed income) market. Governments, municipalities and corporations sell bonds to investors in order to raise capital. When you buy a bond, you are lending money to one of these entities for the promise of repayment with a definite annual return over a determined period of time, hence the term "fixed income." For the vast majority of retirement investors, appropriate asset allocation calls for the inclusion of bond funds in varying degrees. Due to certain economic factors, the fixed income portion of investors' portfolios has started to draw a lot of attention in the media. In this issue of The Retirement Report we intend to define some key elements of bonds, and help readers better understand the asset class.

Why Do Bond Prices Fluctuate?

In order to understand how interest rates affect bond prices, one must realize that there is an inverse relationship between the price of a bond and current interest rates. In other words, bond prices increase when interest rates fall, and vice-versa. The reason for this is simple. If you hold a 10-year bond at a 5% interest rate and rates slip to 4%, your bond becomes more valuable. Investors would pay more money for a bond that has a 5% interest rate when new bonds have a 3% interest rate.

On the other hand, if interest rates increase to 6%, the value of your bond is reduced because investors can buy a bond offering more interest in the open market. To attract investors to your bond, your price must be reduced. This concept is commonly referred to in the finance industry as "interest rate risk."

Interest rate risk can be reduced in a retirement portfolio by investing in bonds with various maturity dates. Long-term, intermediate-term, and short-term bonds all have different exposure to interest rate risk. There is a greater chance that interest rates will fluctuate more significantly over a ten year period than a one year period, so there is a greater likelihood that the value of long-term bonds will be negatively impacted by changes in the interest rate, compared to short-term bonds. Therefore, long-term bonds have more exposure to interest rate risk than short-term bonds. On the other hand, long-term bonds typically offer higher initial interest rates than short-term bonds in order to compensate the investor for the additional interest rate risk he/she takes on. In order to build the most efficient portfolio, diversify your assets across multiple fund types of bonds, and maintain a long-term focus.

Why is This Important Now?

In an attempt to stimulate the economy, the Federal Reserve began slashing interest rates during the 2008 recession, and rates continue to remain at all-time lows today.

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Enter the almighty power of speculation. Many financial professionals have started to tout the obvious; interest rates can't remain this low forever. That is certainly a true statement, but while it is widely believed that rates will begin to steadily rise sometime over the next few years, when and how much interest rates will increase is anyone's guess.

As previously mentioned, when interest rates go up the value of current bond holdings is diminished. As a result, investors may experience short-term losses on the fixed income portion of their portfolios when interest rates eventually increase. This unfortunate fact is exactly what we anticipate the headlines and talk shows to be inundated with in the coming months, and the "news" will only get worse as interest rates do begin to change. However, you should not change your investment strategy based on speculation or in attempt to profit from short-term changes in the market. Maintaining the appropriate asset mix for your age and time horizon and continually contributing to your account is always a winning strategy.

Why Are Bonds Important?

Bond funds and stock funds have a low correlation to one another. In other words, they tend to move in opposite directions as market conditions change. As a result, when stocks perform poorly bonds tend to cushion the fall. Bonds act as a shock absorber within your portfolio, and exhibit much less volatility than stocks. Consequently, moving out of bonds in reaction to short- term speculation could prove to be costly since no one can know what the future holds.

Retirement portfolios should be built using long-term objectives, with the understanding that different asset classes (stocks, bonds, and cash) will generally display different reactions to economic and market conditions. The separate components of your retirement account have a specific purpose in the construction of your portfolio. Diversification is key.

Whom do I call for help?

Contact TIAA-CREF for the following:

- > Balances
- > Investment changes
- > Change personal info

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