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Five (easy) ways to prepare for rising interest rates

By JOHN HEINZL

With the Fed poised to start ramping rates, portfolios on both sides of the border will soon face a new market turbulence.

John Heinzl is the dividend investor for Globe Investor's Strategy Lab[1]*. Follow his contributions* here[2]*. You can see his* model portfolio here[3]*.*

We've heard the warnings for years: Interest rates are going to rise.

And what have interest rates done? Dropped like an anvil.

The yield on Canada's benchmark 10-year government bond, for instance, has plunged to less than 1.5 per cent from about 3.5 per cent in 2011. Over the same period, the five-year yield has tumbled to less than 0.85 per cent from more than 2.5 per cent.

So does that mean investors can stop thinking about rising rates? Not at all.

While the Bank of Canada may be in no hurry to hike its overnight rate – it might even cut the benchmark rate again in a bid to rescue the economy from sinking oil prices – it's a different story in the United States. With U.S. employment surging, the Federal Reserve is widely expected to drop the word "patient" from its news release following its March 17-18 meeting, opening the door to a possible rate hike later this year.

Even if Canada lags the United States, eventually rates are expected to rise here as well. In fact, five- and 10-year Canadian government bond yields have already risen about 0.2 percentage points from their lows in early February.

So how should investors prepare? Well, if you already have a properly diversified portfolio, you might not have to do anything. But there are some tweaks others can make to limit the risks – and take advantage of opportunities – that come with rising rates.

Here are some tips based on conversations with portfolio managers.

Climb the GIC ladder

Bond prices fall when interest rates rise, and longer-term bonds are often hit the hardest. For that reason, it may be prudent to shorten the term in your fixed-income holdings. Justin Bender, portfolio manager with PWL Capital, says one solution is to set up a ladder of guaranteed investment certificates with maturities ranging from one to five years. Based on current GIC rates, a five-year ladder would have an average yield of 1.86 per cent, compared with a yield-to-maturity of 1.49 per cent, after expenses, for the iShares Canadian Universe Bond Index ETF (XBB). In addition to having a higher yield, the GIC ladder would have less "term risk" because its average maturity is just three years compared with more than 10 years for XBB. GICs also have a psychological benefit because, unlike bonds, GIC prices don't change when interest rates rise or fall.

Go for dividend growth

Stocks whose dividends rise very slowly, or not at all, are often vulnerable to rising rates because they trade somewhat like bonds, which pay a fixed coupon. Preferred shares are interest-sensitive for the same reason. One solution is to own stocks whose dividends are expected to grow steadily. Some of these companies – utilities, power producers and real estate investment trusts, for example – might still take a hit when rates rise, but their growing dividends should help to limit the downside.

Buy rate-friendly sectors

Some companies actually like rising rates. Life insurers such as Manulife Financial and Sun Life Financial, for example, stand to benefit when rates rise because they can earn higher returns on the bonds they purchase with their premium income. "The Canadian banks should also benefit from rising rates as their net interest margins increase," said Anil Tahiliani, portfolio manager with McLean & Partners Wealth Management. (Net interest margin refers to the difference between what banks earn on loans and what they pay out to depositors and other lenders). Growth-oriented industrial stocks, particularly those tied to the U.S. market, should also benefit because rising rates are usually a sign of economic strength.

Focus on income

If you focus on the growing income your portfolio throws off – as opposed to the fluctuating price of your securities – you'll be less likely to get rattled and possibly do something rash if your stocks fall. "I do not change how I invest based on interest rates or what someone thinks they might do," said Robert Cable, senior wealth adviser with ScotiaMcLeod and author of *Investing on Autopilot*. "If I can get a 3-per-cent yield on a company like Enbridge and have that dividend rise year after year by 10 per cent or more, I don't really care what rates do."

Keep some cash handy

Investors tend to be manic-depressive: they get euphoric during the good times, and despondent during the bad times. If interest rates rise, some investors might get so upset that they dump perfectly good stocks at bargain prices. If that happens, you'll want to have some cash on hand to take advantage of opportunities that emerge. Not only will stock prices be lower, but the yields will be higher. You can accomplish the same thing by reinvesting your dividends.

Closing thoughts

Interest rates may stay down for a while, but if you prepare now, you'll be ready when they eventually do rise. By diversifying across industries, focusing on dividend growth and investing in sectors that stand to benefit from rising yields, you'll be ready for whatever the interest rate gods have in store.

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