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WEALTH MANAGEMENT ADVISOR

HIGHER INTEREST RATES AHEAD?
Bond fund investors need to plan for multiple scenarios

ACCELERATING YOUR MORTGAGE PAYOFF: GOOD IDEA OR WASTED OPPORTUNITY?

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Pass your wealth and values on to loved ones with an incentive trust

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Higher interest rates ahead?

Bond fund investors need to plan for multiple scenarios

With interest rates near historic lows for an extended time, speculation has mounted about when they might head higher. Interest rates and bond prices tend to move in opposite directions, so if rates rise, bond prices likely will fall. Against this backdrop, what should you do if you're currently invested in bond funds?

The coupon vs. the price

First of all, don't panic. The total return of a bond fund comes from two sources: 1) coupon (interest) payments, and 2) price changes of the securities held by the fund. Even in a rising interest rate environment, a portfolio manager can reinvest interest payments in higher-yielding bonds. As bonds held by the fund mature (begin to pay off), principal can be reinvested as well.

Over time, those higher yields can help to offset adverse price changes. How much time? That depends on where interest rates were to start with, how fast they increase and the average maturity of your bond fund. The higher a fund's average maturity, the more sensitive it typically is to shifts in interest rates, and the longer it may take to recover from a period of rapidly rising interest rates.

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Also consider your bond fund's average duration, which measures the percentage change in the value of a bond for each 1% change in interest rates. Although maturity and duration are calculated differently, they both measure sensitivity to rate fluctuations, with higher numbers indicating greater sensitivity.

How do you decide what maturity and duration to look for? Begin by assessing when you'll need the money you currently have positioned in bond funds. If you'll need it relatively soon — one to four years — you may want to keep the majority of your fixed-income capital in short-term bond funds, which tend to be less vulnerable to rising interest rates. If your need for the money is less pressing, longer-maturity funds may be suitable.

Diversifying your holdings

Keep in mind that not all fixed-income investments react the same way in a rising interest rate environment. Funds that invest exclusively in Treasury securities tend to be the most sensitive to interest rate changes. Why? Because Treasuries reside at the top of the credit-quality heap and typically aren't influenced by factors that can affect other fixed-income securities.

What causes changes in interest rates?

Many factors affect the level of interest rates, but there's a basic distinction between regulated interest rates and market-driven rates (yields).

A few key rates are controlled by the Federal Reserve, our nation's central bank. The most notable is the federal funds rate — the overnight rate at which banks can borrow reserves from each other and which helps determine the cost of borrowed money elsewhere in the banking system. The Fed typically lowers the federal funds rate during a downturn to stimulate the economy, but it must eventually raise it again or risk the kind of credit excesses that helped bring on the recent recession.

Conversely, *most* interest rates are market-driven rather than regulated. For example, the rates of Treasury securities are determined by supply and demand. One factor commonly on the minds of bond investors is the potential for inflation to erode the value of their fixed incomes. Consequently, when inflation is expected to worsen, fixed-income investors will normally demand greater compensation in the form of higher yields — in other words, interest rates will rise.

In the case of corporate bond funds, for example, the adverse effects of rising interest rates might be cushioned by improving earnings prospects for some companies in the fund's portfolio and upgraded credit ratings for their debt. In particular, high-yield bonds can increase in value if they're upgraded to investment grade, potentially outweighing a rate hike.

There also are funds that invest in floating-rate bank loans whose coupon rates are regularly reset — typically every 90 to 180 days. Even though the yields on such funds respond relatively quickly to fluctuating interest rates, investors should realize that these loans normally carry below-investment-grade credit ratings.

So they're best held during an improving economic environment. Indeed, the risks of "reaching for yield" in a deteriorating economy were made crystal clear during 2008, when virtually all non-Treasury fixed-income asset classes sustained significant losses.

If you believe rising interest rates might be accompanied by worsening inflation, some exposure to a fund that invests in Treasury Inflation-Protected Securities (TIPS) might be in order. TIPS tend to rise in value as inflation and inflationary expectations increase. That said, like other Treasury securities, TIPS do tend to be adversely affected by upward trending interest rates.

Plan your rising rate strategy now

Although rising interest rates can be challenging for bond funds, they're not necessarily a signal to sell those holdings. With the help of your financial advisor, explore how different rising interest rate scenarios might influence your portfolio and then make appropriate adjustments. ■

Accelerating your mortgage payoff: Good idea or wasted opportunity?

If you have spare cash after paying the monthly bills, you might wonder about the wisdom of making extra payments on your mortgage. There are strong arguments on both sides of this matter, making it particularly important to look dispassionately at your situation before making a decision.

What's the payback?

A logical way to begin thinking about this issue is to consider your likely return on investment from extra mortgage payments vs. other investment options. This comparison isn't as straightforward as you'd think.

When you pay down a 5% mortgage you might think your return on that money is 5%. Don't forget, though, that mortgage interest is an item you can deduct in calculating your taxable income. If, for example, you're in the 35% tax bracket, this deduction may save you 35% on any mortgage interest payments you make, which means you're effectively paying only 65% (100% minus 35%) of 5%, or 3.25%.

Granted, these are challenging times for investors, but if you think you have a reasonable chance to do better than 3.25%, it may well make sense to try. (Bear in mind that past performance doesn't guarantee future results. Investment returns fluctuate so that an investor's shares when redeemed may be worth more or less than their original cost. Current performance may be lower or higher than the performance data.)

Consider other options

Before allocating funds for extra mortgage payments, consider paying down credit card or other higher-interest debt. After all, reducing a credit card balance costing you 18% (or even 12%) annually provides a significantly greater benefit than making extra payments on a 5% mortgage. Plus, unlike mortgage interest, nonbusiness credit card interest isn't deductible.

Another relatively painless decision is to max out contributions to your 401(k) or IRA, if you're not doing so already. This not only will reduce your taxable income and position you to reap the benefits of tax-deferred compounding, but also may allow you to enjoy additional matching contributions if your employer provides them. Given these advantages, adding to your retirement account is typically a smarter move than paying down your mortgage.

Along similar lines, if you work for a public company and your employer allows you to purchase shares of that stock at a discount, investing in it might provide a better return. Just be aware that large holdings in one stock can jeopardize your portfolio's diversification.

Look at liquidity

When considering alternatives to paying down your mortgage, there's more to look at than simply where your return might be greater. It's a good idea to set aside cash for an unexpected hardship, so consider accumulating at least six months of living expenses if you don't already have that much set aside.

Stockpiling cash makes sense in part because the money is readily accessible. Conversely, after you make payments on a conventional mortgage, it can be difficult to access the money. You may be able to get a home equity loan or line of credit, but it's harder to do than it was a few years ago.

If you encounter financial difficulties, you might be glad you don't have so much wealth tied up in your home. For example, consider the dilemma of people who bought homes in high-priced markets in 2005 or thereabouts and made extra mortgage payments for several years, only to see the value of their residences collapse during the recent financial meltdown.

Many of these homeowners are now "upside-down" — that is, they owe more than their home is worth. If they walk away from their mortgage, they'll forfeit all of those extra payments.

Do what's right for you

Despite these considerations, many people have an abiding conviction that paying off their mortgage as quickly as possible is the right thing to do. Indeed, for those people who can do so without jeopardizing their financial well being, extra mortgage payments — or a mortgage with a shorter term — might be the right choice, regardless of the arguments to the contrary.

Such people often look ahead eagerly to the day when they'll own their home free and clear. If you're one of these people, give these strong emotions their due and consider them along with the other factors specific to your situation. ■

Life's uncertain — consider disability insurance

You never know when an injury or illness might affect your income-earning ability. To financially protect your family and give yourself peace of mind, assess your disability insurance coverage* and determine whether you need to purchase an individual policy.

Employer coverage may be inadequate

Most people receive short-term disability coverage — for disabilities lasting anywhere from two weeks to two years — through their employers. Less common but no less important is long-term coverage. Unfortunately, even when an employer provides long-term coverage, the amount of that coverage often is inadequate.

If your employer doesn't offer disability insurance or provides less than adequate coverage, consider buying an individual policy. This type of policy may offer several important benefits not provided by group coverage.

First, it's portable, meaning your policy will stay in force even if you leave your job. Second, disability income received from an individual policy is income-tax free, as long as you pay the premiums yourself. Finally, an individual policy allows you to decide how much coverage you need.

Cost can be a drawback

The main drawback of buying your own disability insurance policy is that coverage can be expensive. Many factors go into determining the cost, such as your age, your current health status and the amount of coverage you want.

Generally, the older you are or the longer your desired coverage period, the more you can expect to pay in premiums. Also influencing your policy cost is whether your insurer is permitted to raise your premiums ("noncancelable" policies prohibit this as long as you keep paying your premiums) and the length of your "elimination period," or how long you must wait before you begin to receive benefits after a disability.

Coverage amount? No single right answer

Conventional wisdom says you should make sure you're covered for 50% to 60% of your net income. Because there's no single right answer for everyone, sit down and calculate how much money you'd need each month to meet all of your expenses. Your financial advisor can be of help here.

You may be able to save money by not duplicating benefits you already have. For example, if your employer provides short-term disability coverage for one year, you might want to set your policy's elimination period for at least that long.

While individual disability policies tend to be expensive, trying to save money by skimping on coverage is probably not your best strategy. Less expensive policies often lack important protections and may severely restrict your benefits. Your worst-case scenario would be to suffer a disability and then find yourself without the protection you thought you had purchased.

Don't wait

It's important to assess your disability coverage now, while you're healthy. If you wait and then suffer a disability, unfortunately it will be too late to obtain the coverage you need. ■

* Products available through one or more carriers not affiliated with New York Life, dependent on carrier authorization and product availability in your state or locality.

A guiding light even after death

Pass your wealth and values on to loved ones with an incentive trust

Jane, a widowed mother of two teenagers, has amassed a sizable estate thanks to running a successful business and making shrewd investment choices, as well as receiving life insurance proceeds. Since her husband's death, Jane has raised her children alone and has tried to instill in them the same values and standards as her parents instilled in her.

However, she has seen far too often how inheriting a large amount of money can have a detrimental effect on a young adult's life, and she's worried about what might happen if her children should inherit her wealth before they've gained experience and maturity. Jane discusses her concerns with her estate planning advisor, and he recommends using an incentive trust.

Jane's criteria

An incentive trust will allow Jane to establish specific criteria for her children to meet before becoming eligible to receive the trust's assets. This is a more attractive option to Jane than simply setting a mandatory age for them to begin receiving her estate's assets.

Jane wishes to stress three areas in her incentive trust:

1. Educational goals. The trust's distributions can be contingent on, or limited based on, the children graduating from high school and college and maintaining a certain grade point average.

2. Money management. The trust can be set up to spread distributions over a set amount of time to allow the children to mature and gain knowledge on how to manage their finances.

3. Philanthropic activities. A long-time believer in charitable giving, Jane can build matching donations into the trust to encourage the children to participate in philanthropic activities, such as setting up a foundation or volunteering for community service.

Two additional areas an incentive trust can address are beneficiaries' personal lifestyle choices and professional accomplishments. For instance, to address the former, you can structure the trust to prohibit or limit payouts if a beneficiary abuses drugs or alcohol. And to address the latter, you can increase a beneficiary's payout if he or she, for example, joins the family business.

The trust's enforcer

After learning the benefits of an incentive trust, Jane's first question is: Who will administer and enforce the trust? Her estate planning advisor explains that Jane must choose a trustee — an individual, such as a trusted family member, friend or professional advisor, or an institution, such as a bank or trust company. She can also choose to name both an individual and an institution.

If Jane chooses an individual trustee, that person will be more familiar with her family and may have better insight into her standards and values. A professional trustee, on the other hand, has impartiality on his or her side because a professional trustee doesn't have a personal relationship with the beneficiaries. An individual trustee can hire a professional advisor if he or she feels the need to do so.

> An incentive trust's distributions can be contingent on, or limited based on, beneficiaries graduating from high school and college and maintaining a certain grade point average.

The happy ending

Jane is happy that her children will be financially secure after she's gone. With an incentive trust, she has the peace of mind that her standards and values will continue to live on in her children. If you'd like to learn more about incentive trusts, contact your tax and legal advisors. ■

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