Perspectives
THIRD QUARTER 2013

Diversified portfolios can help investors when interest rates rise because different asset classes react differently to changes in rates. Since no one knows exactly when interest rates will rise or fall, a diversified portfolio may also prevent investors from losing out on return opportunities that are available to disciplined investors.

What Happens if Interest Rates Rise?

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It's widely believed that the Federal Reserve will continue its efforts to contain rates until late 2015 or early 2016, but interest rate volatility experienced in May has begun to stir investor concerns regarding interest rate risk. While we believe the short-term likelihood of a significant rise in interest rates remains low, many investors are beginning to ask important "What if" questions surrounding rising rates.

There's not a simple answer as rising interest rates affect different asset classes differently depending on the severity of the increase, the magnitude of the rise and the length of time that passes between each incremental rise.

While past performance is no guarantee of future results, stocks have historically tended to perform well when interest rates first begin to rise. This is based on the assumption that interest rates are rising because economic activity is strong and consumer demand is high. However, there's a limit. When interest rates rise to a point where they begin to stifle economic activity, expectations for future growth and earnings potential recede, hurting stocks. Conversely, fixed-income securities will generally experience a more difficult time as rates rise. Broadly speaking, the longer the duration of a fixed income investment, the more it is expected to be affected.

For bond funds, the main concern during a rising rate environment is that owning bonds through a fund eliminates the ability for investors to choose to hold individual bonds until maturity. The implication is that as interest rates rise, bond prices within a fund generally fall. When a fund manager sells bonds that have lost value, they effectively make those losses permanent for bond fund investors.

While bond fund investments may not be appropriate for all investors, especially those who aren't reinvesting the income produced by the funds, they can provide benefits to long-term, strategically-allocated investors. In particular, many bond funds have the flexibility to opportunistically invest in different areas of the bond markets as conditions change. This not only provides diversification benefits, it also means that fund managers can attempt to avoid segments of the market that are expected to be most affected by increases in interest rates. They can also focus on investing in areas that are likely to provide higher yields while carefully considering other risks like credit quality. Credit quality is of particular interest in today's market as investors seeking higher yields have driven up prices in lower-quality segments of the market to a point that exposes them to significant credit spread expansion risk.

When looking at bond fund returns, it's important to understand that there are two components to total return: capital appreciation and income. When interest rates rise, bond fund investments generally experience a capital loss, just like most other fixed income investments. However, offsetting that capital loss is the income produced by the bond fund. When reinvested, this income enters at a higher yield. As time passes, the ongoing reinvestments will become an important part of the total return received from the fund investment.

Danger in Focusing on Only One Risk

An important behavioral aspect of focusing too narrowly on interest rate risk is that investors may lose sight of the big picture. Rising rates are only one of a myriad of risks to consider when making investment decisions. The possibility of rising rates should not keep investors from considering other potential risks like future market disruptions or the erosion of purchasing power due to inflation.

Ultimately, no portfolio is free of all risks. As an investor, you have to decide how much of each type of risk you are willing to accept in order to achieve the returns you seek. Contact your wealth management advisor to construct or identify a diversified portfolio that is designed to meet your risk profile and cash flow needs.

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Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Evaluating Your Need for Long-Term Care

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What if I had a stroke? What if I am diagnosed with cancer, Alzheimer's or have an auto accident? How will I be able to pay for my care? Those are questions that many of the 10,000 baby boomers retiring each day are asking themselves. Unforeseen illnesses and dramatic events that require long-term care can easily deplete what was once thought to be a comfortable retirement nest egg. Recent research from Genworth Financial shows that the median annual rate for a room in a private nursing home has risen over 24 percent since 2008 to $83,950[1]. Those remaining in their homes but requiring in-home care can expect to pay $19 an hour for a licensed home health aide or $18 an hour for a helper, according to the Genworth survey.

With costs rising, one way you can alleviate some of the financial burden is to purchase a long-term care (LTC) insurance policy. LTC policies can provide essential funds needed to pay for nursing or in-home care.

Is There an Ideal Age to Purchase LTC?

The cost of coverage rises as you get older. While the ideal age to purchase LTC is up for debate, most people can purchase reasonably priced policies during their 50s. This is often the optimal time for two reasons: 1) Most people are relatively healthy at this time and have a reasonable expectation that their health will not improve as they age, 2) They have more disposable income due to financial obligations to children abating, less mortgage liabilities and/or incomes at or near their highest levels.

The premium on a LTC policy at age 50 will be significantly lower compared to 60 or 65. For instance, a LTC policy for a male that provides $150 of coverage per day for three years with a 5 percent increase each year at the standard married rate would cost approximately $1,829.67 at age 50. However, the cost jumps to $2,406.45 and $3,219.70 at age 60 and 65, respectively. That's a 76 percent difference between ages 50 and 65.

Cost is not the only consideration either. Insurability also decreases as you get older. The percentage of Americans who are declined coverage is 24 percent at ages 60-69 and the rate of those declined coverage jumps to 41 percent for people ages 70-79.[2]

What Do Insurance Companies Look at to Determine Pricing and Eligibility?

Gender

Gender has not historically been a significant pricing factor. However, that has changed recently as some carriers have instituted gender-based pricing models. We expect this trend to spread throughout the industry. This first round of changes affected women the most, with pricing increases between 20-40 percent. This is because women will most likely have more claim dollars paid to them versus men. One carrier's statistics show that women receive two-thirds of all claims paid.

Age

Another major consideration in pricing is of course age. As one increases in age, they likelihood of a LTC event increases and premiums must increase to reflect this. You will generally begin to notice considerable year-over-year increases once you reach your mid 60s and dramatic year-over-year increases in your 70s for a newly issued policy.

Benefit Construction

Traditional LTC is very customizable. In general, you have four core decisions to make as you build your policy: 1) Benefit Amount, 2) Benefit Period, 3) Inflation Protection and 4) Elimination Period. Of the four core decisions, inflation protection may have the greatest impact and as such carriers have begun to offer more inflation protection options such as 3 percent compound or inflation protection for 20 years versus a lifetime to assist consumers in keeping premium cost as low as possible.

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1 "Genworth 2013 Cost of Care Survey," March 18, 2013.
2 "The 2012-2013 Sourcebook for Long-Term Care Insurance Information," American Association for Long-Term Care Insurance.