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3. SHARON, MASS.
4. LOUISVILLE, COLO.
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THE 5 BEST BIG CITIES

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Invest

A Not-So-Scary Ride

WORRIED ABOUT RISING RATES? WITH ONLY A MODEST BUMP EXPECTED FROM THE FED, THE MARKETS MAY NOT BE THROWN FOR A LOOP. *by* **Carla Fried**

EVER SINCE the Federal Reserve pushed short-term interest rates near zero in the financial crisis, Wall Street has warned of a coming fright. Once rates ratchet back up, like a lift hill on a roller coaster, your portfolio was said to be set up for a big fall.

Yet even if the Fed hikes rates later this year for the first time in more than nine years, as is widely expected, the reality of rising rates seems a lot less stomach churning than it did just a few months ago. Why? There's a growing belief that the coming rate hikes will be slow and slight. While policymakers believe the economy is strong enough to start pushing up the Federal funds rate

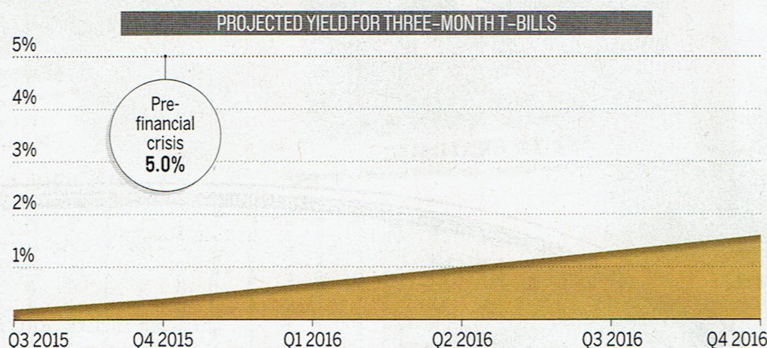
PROP STYLING BY JARED LAWTON

Photograph by GREGORY REID

WHAT, ME WORRY?

If history is a guide, investors may be overly concerned about the impact of rising interest rates on the markets later this year. Why?

1 The consensus forecast among economists is that short-term interest rates will climb, but only modestly—less than two percentage points by the end of 2016.



NOTES: Market data since 1945. Modest rate increases are cumulative Fed hikes of less than three percentage points. Bond data based on periods of modest rate increases. SOURCES: Blue Chip Economic Indicators Survey, July 2015; S&P Capital IQ; Ibbotson Associates

(which is what banks charge one another on overnight loans), they also recognize that a quick and precipitous climb isn't warranted, since wage growth and inflation remain muted.

In July, Fed vice chairman Stanley Fischer said as much when he warned that inflation is too low and "we need to get it back up to 2%." To achieve that, the Fed's stated goal is to push rates up slowly over years, not months. That suggests the Federal funds rate may remain below 2% at the end of 2016—three percentage points less than before the financial crisis.

Another reason for Fed chair Janet Yellen to go slow: A new crop of concerns, such as the Greek debt crisis and China's stock slide, has complicated matters for the global economy (see story on page 78).

"Moderately rising interest rates are not bad news for stocks," says Chris Cook, president of Beacon Capital Management. "It means the economy is doing better." Indeed, in past periods of slight rate increases since World War II, the S&P 500 has generated decent returns (see chart).

Nor is it disastrous for fixed income, even though bond prices fall when rates rise. "The majority of your total return comes from the yield, not price changes," says Cook. "If we don't have steep rate increases—and it looks as if that's not likely—then your rising income payouts will soon make up for any price drops."

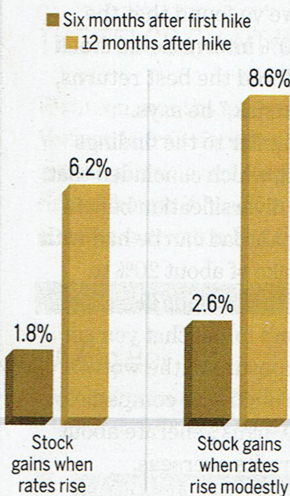
Yet even if things aren't going to get topsy-turvy, you still need to buckle up. Here are steps to take before the Fed makes its move.

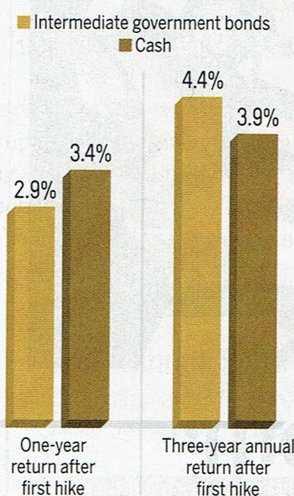
YOUR BEST STOCK MOVES

Seek higher-grade companies. Financially questionable businesses benefited from low rates in a couple of ways. Cheap capital encouraged investors to speculate in lower-quality names. Moreover, companies that must borrow heavily enjoyed cheap rates. As yields rise, though, highly indebted businesses will face head-winds. This gives an edge to companies with low debt and strong balance sheets, like those found in **PowerShares S&P 500 High Quality ETF** (SPHQ).

Also, keep in mind that this is a mature rally in its seventh year, where growth "isn't expected to accelerate much," says Brad Sorensen, head of market and sector analysis for the Schwab Center for Financial Research. So now's the time to look for companies with a solid earnings outlook. Sorensen recommends focusing on places such as tech, where "there's potential for growth as companies reinvest in technology now that productivity has been flat," he says. He also thinks health care—with the exception of small, speculative biotech stocks—looks promising, as it's a defensive sector where profits are growing faster than in the broad market. Where to find this mix? MONEY 50 fund **Primecap Odyssey Growth** (POGRX) has nearly two-thirds of its assets in health care and tech.

Switch dividend gears. If you shifted into high-yielding stocks in recent years to boost your income, it's time for a new approach. Not only are those shares expensive, but high-yielding sectors like utilities are also likely to fall out of favor once bond rates rise, says Sorensen. Instead, go with companies that are financially strong enough to grow dividends over time. **Vanguard Dividend Appreciation ETF** (VIG) looks for high-quality companies that have raised their payouts for at least 10 straight years. And the fund yields 2.2%.





Don't retreat from the world. If the U.S. economy is so healthy, why bother going overseas? Here's why: In the eight most recent periods of rising rates, U.S. stocks lagged foreign developed-market shares 88% of the time and emerging-market equities 75% of the time. "U.S. stocks have had a great run since 2009, and we're now at a stage where we could see the passing of the baton to other markets," says Dan Morris, global investment strategist for TIAA-CREF.

If you haven't adjusted your stock portfolio, now's a smart time (see "Balancing Your Foreign Holdings" on page 52). Because U.S. stocks doubled the return of international stocks over the past five years, a stock strategy that aims to have 20% invested abroad is now closer to 14% foreign.

YOUR BEST BOND MOVES

Come out of the bunker. If in anticipation of rising rates you shifted into short-term bond funds, consider a return to a core, intermediate-term fund such as MONEY 50 pick **Vanguard Total Bond Market Index** (VBMFX).

For starters, Total Bond's 2.4% yield is 1.2 points higher than the payout for Vanguard Short-Term Bond Index. "With moderately rising rates, what matters is having a yield cushion to absorb the price drop," says James Kochan, chief fixed-income strategist at Wells Fargo Advantage Funds. Short-term funds paying 1% offer little defense.

> "MODERATELY RISING INTEREST RATES ARE NOT BAD NEWS FOR STOCKS."
> —CHRIS COOK, PRESIDENT, BEACON CAPITAL MANAGEMENT

Moreover, while short-term debt is affected by Fed hikes, longer-term bonds dance to the beat of the market. Since U.S. bonds already pay more than most foreign-government debt, global demand for longer-term U.S. debt should remain strong. That is likely to keep longer-term rates from rising too much as rising prices mean lower yields.

Be careful not to go too far out. Kochan recommends funds with durations of five to seven years. Duration measures an investment's sensitivity to rate changes. A one-point rise in rates translates to a 5% price decline for a fund with a five-year duration. Vanguard Total Bond Market's duration is 5.6 years. Beyond seven years, your fund's yield may not be able to offset price declines for several years.

Reach for yield carefully. The returns for high-yield corporate bonds are driven more by the economic outlook than by interest rate changes. And since the Fed is about to hike rates because of the strength of the economy, the 5.4% yield of MONEY 50 fund **Fidelity High Income** (SPHIX) may be enticing. Remember that these bonds exhibit stocklike volatility in times of market stress. So if you carve out a 10% allocation, take it from your stock portfolio, not fixed income. Fidelity High Income lost nearly 24% in 2008, while an index of high-grade bonds rose 5%. ■