How Rising Interest Rates Affect Bond Funds

LOCKTON RETIREMENT SERVICES

Changing interest rates are one of the Federal Reserve's best tools for accomplishing its main goals: Full employment and price stability. Low interest rates encourage people and businesses to borrow and buy, which stimulates the economy and creates jobs. Higher interest rates encourage savings which helps slow inflation and rising prices.

HOW DOES THIS AFFECT YOU? MAYBE IT DOESN'T.

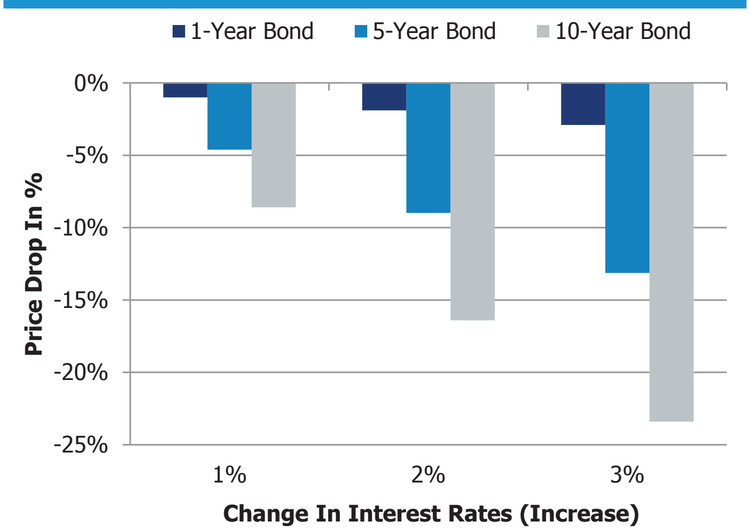
> Most experts agree:
> **The Federal Reserve will continue to raise interest rates.**

Interest rate movement is, typically, an example of a short-term market activity—something that causes an immediate up or down change in fund prices, but something that also tends to normalize over time. As a result, gains or losses due to movements are typically short-term. Since most people in retirement plans are long-term investors, they expect these incremental movements and don't make major shifts because of them. Every once in a while, they rebalance their portfolios to make sure the mix of stocks and bonds and domestic and international funds suits their risk tolerance. But they don't try to time market events for short-term gains or to avoid short-term losses. Anticipating what will happen with that precision is usually too complex.

What to Expect

If interest rates rise, existing bond prices go down because newly issued bonds will have better rates. The reverse happens to bond prices if rates decline. Bonds pay specific amounts of interest for specific periods of time, so the biggest change happens with the longest-term bonds. Buyers pay less for bonds that have lower interest rates than the current market rate for similar bonds and the longer the buyer will be stuck with a low rate, the less he or she is willing to pay.

HOW RISING RATES IMPACT BOND PRICES



Source: Lockton

SPEAKING "FIXED INCOME"

Bonds are loans to business or government organizations. They pay interest to the bond holders.

Fixed Income Funds are bundles of individual bonds which can be bought or sold along with their remaining interest payments. These bundles are overseen by a professional investment manager who watches the market and trades the bonds based on rising and falling rates, trying to get the best overall yield.

Interest Rate is the annual amount paid for using borrowed money.

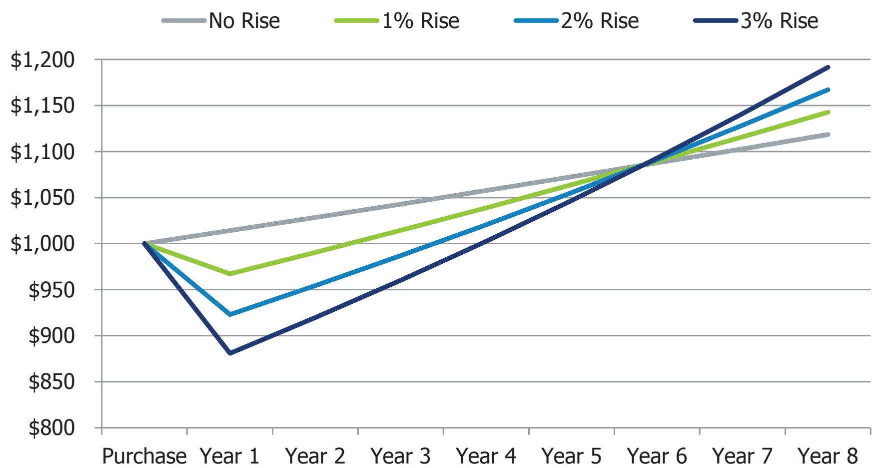
Yield measures the amount of bond interest earned per dollar of bond price. When the price falls, the yield rises and vice versa.

Total Return, for Fixed Income Funds, includes the change in price of an investment over time along with any interest payments.

Money Management Matters

Retirement plans often have fixed income funds, managed professionally, which include a mix of bonds—treasury, corporate, mortgages, etc. The mix may include government and corporate securities, short- and longer-term securities and securities of differing quality levels. Troubled businesses may represent a higher risk that they'll be unable to pay back a loan but, because of this, they pay higher interest rates. Secure businesses represent less risk but, they also negotiate better rates. Having a mix of all of these helps diversify risk and return.

HYPOTHETICAL FIVE-YEAR BOND PORTFOLIO: TOTAL RETURN WITH REINVESTMENT



While a bond portfolio may experience short-term losses following an increase in rates, it should experience higher returns over time.

Source: Lockton

Your employer is responsible for choosing and monitoring the funds in your plan to make sure they perform well and for a reasonable price when compared to other, similar funds. The combination of professional money management and responsible oversight is intended to give you confidence in the quality of your plan's investment options.

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