Scarsdale Investment Group, Ltd.

All Bond Portfolios

Interest Rates Have Gone Up – A Good News Approach!

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Conclusion: Rising interest rates is good news for individual investors looking to create more cash flow. If the value of your individual bonds and bond fund assets are declining, how could this be positive news?

Despite the learned analysis by brilliant commentators, no one really knows why interest rates go up or down in the short term or long term. Rationales are put together that seem to make sense in retrospect. In fact financial writers have a list of reasons, selecting two from column A and one from column B, to best describe the circumstances. As one **New York Times** financial writer said to us: “How would you write a daily column about market movements?” Is there another way?

The media is currently bewailing the fact that interest rates have gone up and the value of bond portfolios have gone down. They count this as very bad news. However, this is only bad news if you are trading your bonds, or are invested in bond funds.

A client has asked whether our strategy around creating bond ladders has changed as a result of the increase in interest rates. The short answer is “no” and here is why.

Our Cash Flow Strategy

Our strategy is based upon generating a reliable cash flow from a portfolio of individual bonds. Our strategy is to buy and hold bonds until they are called or come due. The bonds are self-liquidating and there is no need to find a buyer.

When the price of your bonds fluctuate, due to a change in the market interest rates, your coupons do not change. Accordingly, your *cash flow* stays the same until your bonds are called or come due. Thus, the price of your bond is not significant unless you sell before the call or due date of the bond.

If market interest rates go up, that is the <u>upside</u> case in our strategy. The reason is that when you contribute new money to your account or reinvest bond interest and principal, you will invest at a higher yield. That is the good news. Reinvestment results in growth.

We note that our strategy is rather unique and is contra to everything you will read by the “experts”. They are viewing individual investors as institutions who must “mark-to-market” thereby viewing the value of bonds day-to-day as measures of performance. If interest rates go down and the value of the bond goes up they are winners and if interest rates go up they are losers.

Also keep in mind that the financial services industry lives on <u>transactions</u> and any price movement is an opportunity for them to advise everyone to trade.

<u>A Tax Strategy</u>

We make a possible exception to our general rule of not selling bonds if you are taking big stock market or real estate gains. The current market environment provides an opportunity to sell bonds that may result in a tax loss. If you recognize a tax loss in the sale of your bonds, this capital loss can be used to offset recognized capital gains, or may create a capital loss carry-forward that can be used in subsequent years to offset income and capital gains. In addition, in certain circumstances, up to $3,000 in net capital losses can be used to offset ordinary taxable income. If you are interested in these ideas, you should have a conversation with your accountant about them.

<u>Our Conclusion:</u> Focus on cash flow. Today is a better time to invest than one year ago since the interest rates are higher. You can purchase high quality taxable bonds yielding 4%+. On the tax-exempt side, yields on long term bonds are approaching 4% as well. You can increase your cash flow and lock it in by investing in higher yielding, high quality bonds. This is especially important if you are sitting on large sums of idle cash. It is also possible to purchase shorter term securities at attractive prices.

Our strategy is unchanged for the last 25 years and has worked through all kinds of financial markets. In other words, the strategy works TO PROTECT PRINCIPAL AND CREATE A RELIABLE CASH FLOW.

Make an appointment to speak with Hildy or Stan Richelson if you wish to discuss this strategy in more detail.