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Capital Advice

Capital Financial Advisors of New York, LLC

How Interest Rates Effect Bonds

The Federal Reserve will probably raise interest rates sometime this year. With the first meaningful rise in interest rates in four years, it is natural to wonder what will happen to interest-paying investments, most notably bonds. The short answer is that bonds will go down in value. Bonds decrease in value when interest rates rise because investors are given a choice. They can buy bonds with the new, higher interest rates or bonds with the old, lower interest rates. Since we all want higher interest rates, the bonds with the higher interest rates will cost more than those with the lower interest rates. This means that the older bonds will have lower values.

So, what does this mean for my investment portfolio? I have a lot of bonds, will I lose money? The answer depends on how you own your bonds. If you own individual bonds and if you don't sell your bonds, you don't lose anything. Bonds have a stated maturity, which means they will return your money to you at a specific date in the future, baring a default. Along the way, you will receive interest. The bond's interest payments do not change as interest rates change. The yield, or interest you are promised, is locked in when you purchase the bond. And while the value of the bond will change with changes in market interest rates, the money you receive will not change.

If, on the other hand, you own your bonds in a bond mutual fund, you may lose money if rates rise whether you sell the mutual fund or not. The reason for this is that you share your bonds with many other investors. Unfortunately, many other investors have a tendency to do the opposite of what a good investor does, they sell low and buy high. Even if you are disciplined enough to ride out the rising rate storm, many of your fellow bond mutual fund investors will not. When the undisciplined investors sell their shares of the bond mutual fund, the mutual fund must sell bonds at lower values. This means that the sellers have locked in losses for themselves and for you.

Although a rise in interest rates won't affect what you earn from your individual bonds, none of us likes to see our investment values drop. What can we do? The easy answer is that we should wait for bond yields to go up. The problem is that we don't know when they will go up. Pundits have been saying that bond yields would go up for the last six years. Yet, except for a couple of quickly reversed increases, bond yields have gone down. Anyone who has been waiting for bond yields to go up as the country was coming out of the Great Recession has missed out on six years of interest that could have been earned.

What should we do? We can either match up the cash flows --the interest and principal payments -- from the bonds we buy to what you need or we can build bond ladders. A bond ladder is a bond portfolio that has bonds maturing each year from now until sometime in the future. Bond ladders continually have bonds maturing. When bonds mature, the proceeds are used to buy new bonds at the higher expected interest rates. Moreover, including bonds with different maturities also smooths out changes in the value of bonds as interest rates change. Bonds that have higher interest payments are also less sensitive to changes in interest rates.

Lastly, it's reasonable to ask whether we should own bonds since we are pretty sure interest rates are going up and bond values are going down. We believe we should. Bonds insulate your portfolio from the ups and downs of the equity markets. In times of market stress, bonds typically increase in value offsetting declines in stock values. They also continue to make interest payments when stock dividends go down or are suspended. Bond values may temporarily decline in value; however, if you own individual bonds, the money you earn will not change.

In psychology, "heuristics" refers to the mental decision-making short-cuts that individuals develop over time based on past experiences. While heuristics can be helpful in avoiding unnecessary deliberation, they can also lead to misleading biases that can derail even the most well-thought-out financial plan.

Investor, Know Thyself: How Your Biases Can Affect Investment Decisions

Traditional economic models are based on a simple premise: people make rational financial decisions that are designed to maximize their economic benefits. In reality, however, most humans don't make decisions based on a sterile analysis of the pros and cons. While most of us do think carefully about financial decisions, it is nearly impossible to completely disconnect from our "gut feelings," that nagging intuition that seems to have been deeply implanted in the recesses of our brain.

Over the past few decades, another school of thought has emerged that examines how human psychological factors influence economic and financial decisions. This field--known as behavioral economics, or in the investing arena, behavioral finance--has identified several biases that can unnerve even the most stoic investor. Understanding these biases may help you avoid questionable calls in the heat of the financial moment.

Sound familiar?

Following is a brief summary of some common biases influencing even the most experienced investors. Can you relate to any of these?

1. **Anchoring** refers to the tendency to become attached to something, even when it may not make sense. Examples include a piece of furniture that has outlived its usefulness, a home or car that one can no longer afford, or a piece of information that is believed to be true, but is in fact, false. In investing, it can refer to the tendency to either hold an investment too long or place too much reliance on a certain piece of data or information.
2. **Loss-aversion bias** is the term used to describe the tendency to fear losses more than celebrate equivalent gains. For example, you may experience joy at the thought of finding yourself $5,000 richer, but the thought of losing $5,000 might provoke a far greater fear. Similar to anchoring, loss aversion could cause you to hold onto a losing investment too long, with the fear of turning a paper loss into a real loss.
3. **Endowment bias** is also similar to loss-aversion bias and anchoring in that it encourages investors to "endow" a greater value in what they currently own over other possibilities. You may presume the investments in your portfolio are of higher quality than other available alternatives, simply because you own them.
4. **Overconfidence** is simply having so much confidence in your own ability to select investments for your portfolio that you might ignore warning signals.
5. **Confirmation bias** is the tendency to latch onto, and assign more authority to, opinions that agree with your own. For example, you might give more credence to an analyst report that favors a stock you recently purchased, in spite of several other reports indicating a neutral or negative outlook.
6. The **bandwagon effect,** also known as **herd behavior,** happens when decisions are made simply because "everyone else is doing it." For an example of this, one might look no further than a fairly recent and much-hyped social media company's initial public offering (IPO). Many a discouraged investor jumped at that IPO only to sell at a significant loss a few months later. (Some of these investors may have also suffered from overconfidence bias.)
7. **Recency bias** refers to the fact that recent events can have a stronger influence on your decisions than other, more distant events. For example, if you were severely burned by the market downturn in 2008, you may have been hesitant about continuing or increasing your investments once the markets settled down. Conversely, if you were encouraged by the stock market's subsequent bull run, you may have increased the money you put into equities, hoping to take advantage of any further gains. Consider that neither of these perspectives may be entirely rational given that investment decisions should be based on your individual goals, time horizon, and risk tolerance.
8. A **negativity bias** indicates the tendency to give more importance to negative news than positive news, which can cause you to be more risk-averse than appropriate for your situation.

An objective view can help

The human brain has evolved over millennia into a complex decision-making tool, allowing us to retrieve past experiences and process information so quickly that we can respond almost instantaneously to perceived threats and opportunities. However, when it comes to your finances, these gut feelings may not be your strongest ally, and in fact may work against you. Before jumping to any conclusions about your finances, consider what biases may be at work beneath your conscious radar. It might also help to consider the opinions of an objective third party, such as a qualified financial professional, who could help identify any biases that may be clouding your judgment.

Don't assume that Social Security is just for retirees; it's much more than a retirement program. According to the SSA, approximately 21% of individuals currently receiving benefits are younger than retirement age who are receiving disability or survivor benefits. Get in the habit of checking your Social Security Statement every year to find out what role Social Security might play in your financial future.*

**Source: Fast Facts & Figures About Social Security, 2014*

No Matter What Your Age, Your Social Security Statement Matters

Fifteen years ago, the Social Security Administration (SSA) launched the Social Security Statement, a tool to help Americans understand the features and benefits that Social Security offers. Since then, millions of Americans have reviewed their personalized statements to see a detailed record of their earnings, as well as estimates of retirement, survivor, and disability benefits based on those earnings. Here's how to get a copy of your statement, and why it deserves more than just a quick glance, even if you're years away from retirement.

How do you get your statement?

In September 2014, the SSA began mailing Social Security Statements to most workers every five years. Workers attaining ages 25, 30, 35, 40, 45, 50, 55, and 60 who are not receiving Social Security benefits and are not registered for an online account will receive a statement in the mail about three months before their next birthday. Workers older than age 60 will receive a statement every year.

But why wait? A more convenient way to view your Social Security Statement is online. First, visit socialsecurity.gov to sign up for a personal *my* Social Security account (you must be 18 or older to sign up online). Once you have an account, you can view your Social Security Statement anytime you want, as often as you want.

Check your estimated benefits

Your Social Security Statement gives you information about retirement, disability, and survivor benefits. It tells you whether you've earned enough credits to qualify for these benefits and, if you qualify, how much you can expect to receive. As each Social Security Statement notes, the amounts listed are only estimates based on your average earnings in the past and a projection of future earnings. Actual benefits you receive may be different if your earnings increase or decrease in the future. Amounts may also be affected by cost-of-living increases (estimates are in today's dollars) and other income you receive. Estimated benefits are also based on current law, which could change in the future.

Retirement benefits

Although Social Security was never intended to be the sole source of retirement income, retirement benefits are still very important to many retirees. Your statement shows estimates of how much you can expect to receive if you begin receiving benefits at three different ages: your full retirement age (66 to 67, depending on your birth year), age 62 (your benefit will be lower), or age 70 (your benefit will be higher). When to start claiming Social Security is a big decision that will affect your overall retirement income, so if you're approaching retirement, this information can be especially useful. But even if you're years away from retirement, it's important to know how much you might receive, so that you can take this information into account as you set retirement savings goals.

Disability benefits

Disability is unpredictable and can happen suddenly to anyone at any age. Disability benefits from Social Security can be an important source of financial support in the event that you're unable to work and earn a living. Check your Social Security Statement to find out what you might receive each month if you become disabled.

Survivor benefits

Survivor protection is a valuable Social Security benefit you may not even realize you have. Upon your death, your survivors such as your spouse, ex-spouse, and children may be eligible to receive benefits based on your earnings record. Review your Social Security Statement to find out whether your survivors can count on this valuable source of income.

Review your earnings record

In addition to benefit information, your Social Security Statement contains a year-by-year record of your earnings. This record is updated whenever your employer reports your earnings (or if you're self-employed, when you report your own earnings). Earnings are generally reported annually, so keep in mind that your earnings from last year may not yet be on your statement.

It's a good idea to make sure that your earnings have been reported correctly, because mistakes do happen. You can do this by comparing your earnings record against past tax returns or W-2s you've received. This is an important step to take because your Social Security benefits are based on your average lifetime earnings. If your earnings have been reported incorrectly, you may not receive the benefits to which you're entitled.

What if you find errors? The SSA advises you to call right away if any earnings are reported incorrectly. The SSA phone number is 1-800-772-1213 (TTY 1-800-325-0778).

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Will I have to pay a penalty tax if I don't have qualifying health insurance?

It depends. One of the main objectives of the health-care reform law, the Patient Protection and Affordable Care Act (ACA), is to encourage uninsured individuals to obtain health-care coverage. As a result of the ACA, everyone must have qualifying health insurance coverage, qualify for an exemption, or pay a penalty tax. This requirement is generally referred to as the individual insurance or individual shared responsibility mandate.

Health insurance plans that meet the requirements of the ACA generally include employer-sponsored health plans, government health plans, and health insurance purchased through state-based or federal health insurance exchange marketplaces.

Individuals who are exempt from the individual insurance mandate include:

- Those who qualify for religious exemptions
- Certain noncitizens
- Incarcerated individuals
- Members of federally recognized American Indian tribes
- Those who qualify for a hardship exemption

Individuals may also qualify for an exemption if:

- They are uninsured for less than three months
- The lowest-priced insurance coverage available to them would cost more than 8% of their income
- They are not required to file an income tax return because their income is below a specified threshold

For tax year 2014, the penalty tax equals the greater of 1% of the amount of your household income that exceeds a specific amount (generally, the standard deduction plus personal exemption amounts you're entitled to for the year) or $95 per uninsured adult (half that for uninsured family members under age 18), with a maximum household penalty of $285. In 2015, the percentage rate increases to 2%, the dollar amount per uninsured adult increases to $325, and the maximum household penalty increases to $975.

What is this new chip-card technology I've been hearing about in the news?

In recent years, data breaches at major retailers have increased across the United States. As a way to counteract these data breaches, many U.S. credit-card companies have started implementing a more secure chip-card technology called EMV (which is short for Europay, Mastercard, and Visa).

Currently, most retailers use the magnetic strips on the back of your debit or credit card to access your account information. Unfortunately, the information contained in the magnetic strips is easily accessed by hackers. In addition, the magnetic strips use the same account information for every transaction. So once your card information is stolen, it can be used over and over again.

With the new EMV technology, debit cards and credit cards are embedded with a computer chip that generates a unique authentication code for each transaction. So if your card information is ever hacked, it can't be used again--it's a "one-and-done" scenario.

While many developed nations moved to EMV technology years ago, U.S. retailers have previously been unwilling to shoulder the costs. Fortunately, there is good news for U.S. consumers on the horizon.

Beginning in 2015, many large retailers will switch to the new EMV technology by installing payment terminals designed to read the new chip-embedded payment cards. It may take additional time, however, for smaller retailers to adopt this latest technology.

Along with EMV, even more advanced encryption technology is being developed that will increase security for online transactions and payments made with smartphones. In fact, new mobile payment options like Apple Pay and Google Wallet could eventually make paying with plastic entirely obsolete.

In the meantime, in the wake of these data breaches, you should make it a priority to periodically review your credit-card and bank account activity for suspicious charges. If you typically wait for your monthly statements to arrive in the mail, consider signing up for online access to your accounts--that way you can monitor your accounts as often as needed.