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Interest Rate Changed - Should Your Portfolio?

This week, the Bank of Canada bumped up the interest rate by 0.25%, to 1.25%. While this decision shows that our economy is strengthening, it raised some concerns among investors, particularly those who own bond funds, also known as fixed income.

The reason for their worry, is that when rates go up, bond prices go down. So this week's rate hike, has led some investors to question whether they should scale back or dump their bond funds.

There are no straight answer to this question because there are a number of variables which are too complex to cover in this one post. But there are a couple of rules of thumb that we can offer to help guide investors.

Bonds Have Different Levels of Sensitivities

Bonds are really just an IOU. When you buy a bond, you're giving a loan, and in return, you get a regular stream of interest payments until the borrower returns your loan in full (i.e. the bond's term).

When rates go up, this has less of an impact on short and medium term bonds (bonds with terms between 1 to 5 years). The simple explanation is that lenders and borrowers only need to accept the lower interest payments for a shorter time. So the recent interest hike had less of an impact on this group of bonds.

Bonds Play a Unique and Important Role

It's important to understand that bonds, like other asset classes, have a specific role in a portfolio. Whereas equities are meant to provide the potential of growth, the main responsibilities of bonds are to provide stability to your portfolio.

As equities and bonds tend to perform in opposite directions. That is, when equities are performing well, bonds are slowing down. Since market conditions change continuously, including a mix of equities and bonds into your portfolio helps to minimize the return fluctuation in your portfolio. This is particularly important for the investors nearing retirement who need more stable and consistent returns.

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