After more than five years of unprecedented support for the economy, the Federal Reserve Board has begun to reduce its purchases of bonds. And though the Fed has said interest rates may stay low even after unemployment has fallen to 6.5%, higher rates increasingly seem to be a question of timing. Both of those actions can affect your portfolio.

**Bond purchases: the tale of the taper**

In the wake of the 2008 credit crisis, the Fed's purchases of Treasury and mortgage-backed bonds helped keep the bond market afloat, supplying demand for debt instruments when other buyers were hesitant. Fewer purchases by one of the bond markets' biggest customers in recent years could mean lower total overall demand for debt instruments. Since reduced demand for anything often leads to lower prices, that could hurt the value of your bond holdings.

On the other hand, retiring baby boomers will need to start generating more income from their portfolios, and they're unlikely to abandon income-producing investments completely. Those boomers could help replace some of the lost demand from the Fed. Also, the Fed's planned retreat from the bond-buying business has roiled overseas markets in recent months; when that kind of uncertainty hits, global investors often seek refuge in U.S. debt.

**Rising interest rates**

When interest rates begin to rise, investors will face falling bond prices, and longer-term bonds typically feel the impact the most. Bond buyers become reluctant to tie up their money for longer periods because they foresee higher yields in the future. The later a bond's maturity date, the greater the risk that its yield will eventually be superseded by that of newer bonds. As demand drops and yields increase to attract purchasers, prices fall.

There are various ways to manage that impact. You can hold individual bonds to maturity; you would suffer no loss of principal unless the borrower defaults. Bond investments also can be laddered. This involves buying a portfolio of bonds with varying maturities; for example, a five-bond portfolio might be structured so that one of the five matures each year for the next five years. As each bond matures, it can be reinvested in an instrument that carries a higher yield.

If you own a bond fund, you can check the average maturity of the fund's holdings, or the fund's average duration, which takes into account the value of interest payments and will generally be shorter than the average maturity. The longer the fund's duration, the more sensitive it may be to interest rate changes. **Note:** All investing involves risk, including the loss of principal, and your shares may be worth more or less than you paid for them when you sell. Before investing in a mutual fund, carefully consider its investment objective, risks, fees, and expenses, which are outlined in the prospectus available from the fund. Read it carefully before investing.

For those who've been diligent about saving, or who have kept a substantial portion of their investments in cash equivalents such as savings accounts or certificates of deposit, higher interest rates could be a boon, as rising rates would increase their potential income. The downside, of course, is that if higher rates are accompanied by inflation, such cash alternatives might not keep pace with rising prices.

**Balancing competing risks**

Bonds may be affected most directly by Fed action, but equities aren't necessarily immune to the impact of rate increases. Companies that didn't take advantage of low rates by issuing bonds may see their borrowing costs increase, and even companies that squirreled away cash could be hit when they return to the bond markets. Also, if interest rates become competitive with the return on stocks, that could reduce demand for equities. On the other hand, declining bond values could send many investors into equities that offer both growth potential and a healthy dividend.

Figuring out how future Fed decisions may affect your portfolio and how to anticipate and respond to them isn't an easy challenge. Don't hesitate to get expert help.
Test Your Knowledge of Financial Basics

Working with a trusted financial professional is one of the best ways to help improve your overall financial situation, but it’s not the only thing you can do. Educating yourself about personal finance concepts can help you better understand your advisor’s recommendations, and result in more productive and potentially more prosperous financial planning discussions. Take this brief quiz to see how well you understand a few of the basics.

Questions

1. How much should you set aside in liquid, low-risk savings in case of emergencies?
   a. One to three months’ worth of expenses
   b. Three to six months’ worth of expenses
   c. Six to twelve months’ worth of expenses
   d. It depends

2. Diversification can eliminate risk from your portfolio.
   a. True
   b. False

3. Which of the following is a key benefit of a 401(k) plan?
   a. You can withdraw money at any time for needs such as the purchase of a new car.
   b. The plan allows you to avoid paying taxes on a portion of your compensation.
   c. You may be eligible for an employer match, which is like earning a guaranteed return on your investment dollars.
   d. None of the above

4. All of the money you have in a bank account is protected and guaranteed.
   a. True
   b. False

5. Which of the following is typically the best way to pursue your long-term goals?
   a. Investing as conservatively as possible to minimize the chance of loss
   b. Investing equal amounts in stocks, bonds, and cash investments
   c. Investing 100% of your money in stocks
   d. Not enough information to decide

Answers

1. d. Conventional wisdom often recommends setting aside three to six months’ worth of living expenses in a liquid savings vehicle, such as a bank savings account or money market mutual fund. However, the answer really depends on your own individual situation. If your (and your spouse’s) job is fairly secure and you have other assets, you may need as little as three months’ worth of expenses in emergency savings. On the other hand, if you’re a business owner in a volatile industry, you may need as much as a year’s worth or more to carry you through uncertain periods.

2. b. Diversification is a smart investment strategy that helps you manage risk by spreading your investment dollars among different types of securities and asset classes, but it cannot eliminate risk entirely. You still run the risk of losing money.

3. c. Many employer-sponsored 401(k) plans offer a matching program, which is like earning a guaranteed return on your investment dollars. If your plan offers a match, you should try to contribute at least enough to take full advantage of it. (Note that some matching programs impose a vesting schedule, which means you will earn the right to the matching contributions over a period of time.)

4. b. Deposits in banks covered by the Federal Deposit Insurance Corporation are protected up to $250,000 per depositor, per bank. This means that if a bank should fail, the federal government will protect depositors against losses in their accounts up to that limit. The FDIC does not protect against losses in stocks, bonds, mutual funds, life insurance policies, annuities, or municipal securities, even if those vehicles were purchased at an insured bank. It also does not protect items held in safe-deposit boxes or investments in Treasury bills.

5. d. To adequately pursue your long-term goals, it’s best to speak with a financial professional before choosing a strategy. He or she will take into consideration your goals, your risk tolerance, and your time horizon, among other factors, to put together a well-diversified strategy that’s appropriate for your needs.
Spring Cleaning Your Debt

It's springtime--time for you to take stock of your surroundings and get rid of the dirt and clutter that you've accumulated during this past year.

In addition to typical spring cleaning tasks, you may want to take this time to focus on your finances. In particular, now may be as good a time as ever to evaluate your debt situation and try to reduce and/or eliminate any debt obligations you may have. The following are some tips to get you started.

Determine whether it makes sense to refinance

If you currently have consumer loans, such as a mortgage or an auto loan, take a look at your interest rates. If you find that you are paying higher-than-average interest rates, you may want to consider refinancing. Refinancing to a lower interest rate can result in lower monthly payments on a loan and potentially less interest paid over the loan's term.

Keep in mind that refinancing often involves its own costs (e.g., points and closing costs for mortgage loans), and you should factor them into your calculations of how much refinancing might save you.

Consider loan consolidation

Loan consolidation involves rolling small individual loans into one larger loan, allowing you to make only one monthly payment instead of many.

Consolidating your loans into one single loan has several advantages, including making it easier to focus on paying down your debt. In addition, you may be able to get a lower interest rate or extend the loan term on a consolidated loan. Keep in mind, however, that if you do extend the repayment term on a consolidated loan, it could take you longer to get out of debt and ultimately you may end up paying more in interest charges over the life of the loan.

Look into taking out a home equity loan

If you own a home and have enough equity, you may be able to use a home equity loan to pay off your debt. The interest on home equity loans is often lower compared to other types of loans (e.g., credit cards) and is usually tax deductible.

Home equity loans can be an effective way to pay off debt. However, there are some disadvantages to consider. If you end up having an available line of credit with a home equity loan, you'll need to be careful not to incur any new debt. In addition, when you take out a home equity loan, your home is potentially at risk since it serves as collateral for the loan.

Evaluate whether you should invest your money or pay off your debt

Another effective way to reduce your debt load is to take cash that you normally would put toward certain investment vehicles and use it to pay down your debt. In order to determine whether this is a good option, you'll have to compare the current and anticipated rate of return on your investments with interest you would pay on your debt. In general, if you would earn less on your investments than you would pay in interest on your debts, using your extra cash to pay off your debt may be the smarter choice.

For example, assume that you have $1,000 in a savings account that earns an annual rate of return of 3%. Meanwhile, you have a credit card balance of $1,000 that incurs annual interest at a rate of 19%. Over the course of a year, your savings account earns $30 interest while your credit card costs you $190 in interest. In this case, it might be best to use your extra cash to pay down your high-interest credit card debt.

Come up with a payment strategy to eliminate credit card debt

If you have a significant amount of credit card debt, you'll need to come up with a payment strategy in order to help eliminate it. Some options include:

• Making lump-sum payments using available funds such as an inheritance or employment bonus
• Prioritizing repayments toward cards with the highest interest rates
• Utilizing balance transfers

Whenever possible, make additional payments

Making payments in addition to your regular loan payments or the minimum payment due can reduce the length of the loan and the total interest paid over the life of a loan. Additional payments can be made periodically and at a time of your choosing (e.g., monthly, quarterly, or annually).

Making more than the required minimum payment is especially important when it comes to credit card debt. If you only make the minimum payment on a credit card, you'll continue to carry the bulk of your balance forward for many years without actually reducing your overall balance.
Will rising interest rates impact my pension benefits?

If you're nearing retirement and plan to elect lifetime payments from your pension plan, rising interest rates won't have any impact on your benefits. But if you're considering a lump-sum payment, rising interest rates can be critical.

Pension plans calculate your lump sum by determining the present value of your future pension payments. The two primary components in this calculation are your life expectancy, and interest rates. Life expectancy is determined using IRS tables. These tables are unisex (that is, the same life expectancy factors apply to both men and women). This results in women getting lump sums that are slightly smaller than they would otherwise get based on true gender-based factors, and men getting slightly larger lump sums.

Until recently, the interest rate plans used to calculate lump-sum payments was the U.S. 30-year Treasury bond rate. However, employers can now use a higher corporate bond rate. What's important to understand is that the amount of your lump sum payment is inversely proportional to interest rates—that is, the higher the rate, the smaller your lump sum.

If your plan offers lump-sum payments, there are two questions you need to ask yourself. First, "Is a lump-sum right for me?" This is a difficult question, and the answer depends on a number of factors. Is the pension your primary source of retirement income? How is your (and your spouse's) health? Will you be giving up valuable subsidized benefits built into the plan's benefit payments, or cost-of-living increases? A lump sum gives you control over your retirement dollars and removes the risk of early death, but shifts the investment risk from the plan to you. Remember that you'll be giving up a benefit payment that's guaranteed for your (and if you're married, your spouse's) life. Will you be able to make your lump sum last for a retirement that may last 30 years or more?

If you decide a lump sum is the right choice, the second question is, "When should I take the money?" Interest rates remain near historic lows, and it's only a matter of time before they start heading back up. If you're approaching retirement and believe interest rates will rise in the near future, you may want to consider taking the lump sum sooner rather than later. Your plan can provide you with an estimate of your lump sum based on various interest rates.