Profiting from higher rates

Advisors should reconsider long-term debt in client portfolios

By Jade Hemeon

The era of bottom-scraping interest rates is approaching its end, and that has implications for your clients' investment portfolios.

The turn in interest rates means it makes sense to stick with either floating-rate vehicles that can ride rates up or fixed-income products with relatively short terms. This is the opposite strategy to what worked when interest rates were falling and clients benefited by holding long-term products that promised higher rates into the future.

"We've been proactive in preparing client portfolios for rate declines for the past six months," says Ted Rechtshaffen, president and CEO of **TriDelta Financial Partners Inc.** in Toronto. "The worst thing now is to be in long-term government debt. It doesn't pay enough interest to make it worth holding, and it could drop in value as market rates go up."

It's anyone's guess how quickly, or by how much, interest rates will rise. But Rechtshaffen points out that the prime rate had notched downward by a dramatic 4.3 percentage points during the 14 months between November 2007 and January 2009 as financial markets unravelled — and the rebound could be as sharp.

On the bond side, advi-sors are steering clients toward short terms, typically in the two- to three-year range. Clients with guaranteed investment certificates are also being moved to shorter time horizons.

For example, Andrew Pyle, a financial advisor with **ScotiaMcLeod Inc.** in Peterborough, Ont., has moved the maximum term for his GIC laddering strategies down to three years from five years. As GICs come due in the next three years, they will be reinvested on a staggered basis at prevailing, and presumably higher, rates.

Pyle is also putting some floating-rate notes into portfolios, which adjust their rates in lockstep with market rates.

Six months ago, Diane McCurdy, president of **McCurdy Financial Planning Inc.** in Vancouver, was putting her clients' cash assets in two-year term deposits; she is now moving to one-year terms, which pay the same 2.1% rate clients were previously getting over two years.

Regarding preferred shares, Pyle is seeking preferreds with dividend-reset facilities, which offer protection against rising interest rates. If rates rise, the corporate issuer of this type of preferred shares has the option of either redeeming the shares at certain times or raising the dividend, which is typically tied to the five-year Government of Canada bond rate. "Preferred shares with reset facilities are a good choice," Pyle says. "Many have yields in the 3% range, which is an advantageous rate even before the dividend tax credit."

Because preferred shares are issued by corporations, not governments, Pyle warns, the risk is higher and the credit quality must be scrutinized.

(The same goes for corporate bonds, which typically pay higher rates than safer government bonds, the differential offering some insulation against rising market rates.)

With rate-reset preferreds trading at a high premium because of rising demand, Barnaby Ross, vice president with **RBC Dominion Securities Inc.** in Toronto, suggests clients can do as well in high-quality common stocks— which can also benefit from the dividend tax credit — such as Telus Corp, BCE Inc. or IGM Financial Inc., that pay a healthy dividend but also have potential to appreciate with growth.

There are also some attractive yields on income trusts, which are required to convert to corporations by 2011.

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