Worried About Rising Interest Rates? Protect Your Money With These 3 Tips

Description

Many Canadian investors haven't experienced a prolonged period of rising interest rates.

The long-term trend has certainly been an investor's friend. Yes, there have been periods when interest rates crept higher, but for the most part, rates have been on a steady downward march over the last 40 years. In the early 1980s, a five-year mortgage rate in Canada was between 15% and 20%, depending on the year. These days, you can lock in a five-year mortgage for about 3%.

This steady move downwards has created an army of overconfident investors, folks who are putting their cash to work under the assumption interest rates will never move meaningfully higher again. But what if they're wrong? These people are setting themselves up for disaster if they are.

Here are a few ways you can hedge your portfolio against rising interest rates.

Buy short-term bonds

Bonds are a great way to protect your portfolio from the day-to-day gyrations of the stock market. Most investors buy bonds through passive vehicles like ETFs, since it's somewhat difficult for retail investors to buy bonds on their own.

There's just one problem, at least when trying to use bonds to protect against rising rates. Most of these ETFs load up on longer-term bonds in an attempt to juice yields. That means they won't perform that well if rates go up.

The solution is to buy a short-term bond ETF or perhaps even put your cash in a high-interest savings account. These products will reflect current interest rates much quicker than something that focuses on longer-term securities.

But investors should be cautious when putting their cash to work in such vehicles. They offer virtually zero upside potential. It's best to not put your whole portfolio there, in other words.

Commodities

Higher inflation tends to lead to higher interest rates. One of the reasons why rates have persistently marched lower over the last few decades is inflation continues to decrease.

When inflation does rear its ugly head again, commodities will likely be a major beneficiary. In fact, some might even take this argument a step further and argue that higher commodity costs — specifically, energy — actually cause inflation, since oil is so prevalent in today's economy.

Sure, you could use oil futures to bet on the price of crude, but I'd rather do it by owning shares of **Suncor Energy** (TSX:SU)(NYSE:SU), an investment that should still end up performing relatively well, even if the higher inflation thesis doesn't pan out.

As the largest energy producer in Canada, Suncor has all sorts of interesting assets. It dominates the oil sands, long-life production that should continue for decades without the need to explore for more. Technological advancements are continually bringing down Suncor's operating costs, too. And the company is growing its offshore energy production as well.

Then there are Suncor's downstream assets, which are a major reason why I bought the stock. It owns four oil refineries with a combined output capacity of approximately 500,000 barrels of oil per day, most of which goes to its +1,500 Petro Canada locations. Earnings from these downstream assets are steady, unlike the volatile oil market.

Finally, Suncor pays a generous dividend — a nice consolation prize while waiting for the energy market to cooperate. The payout is 4.1% and the dividend has been raised each year since 2003.

Avoid real estate

Although real estate is commonly thought of an inflation hedge, I'm not sure it'll work the next time higher inflation causes rates to go higher.

Yes, landlords should be able to raise rents in such a world. And since mortgage rates are locked in — for a little while, at least — this should lead to some increased profits over the short term.

But it's obvious the Canadian real estate market has been propped up by lower interest rates. Higher rates will cause investors to insist on higher cash flows, which will inevitably push prices down. So, even though rates should help rents go up, the overall investment will do poorly.

The bottom line

Although rising interest rates don't seem like a threat today, investors should still guard against it. They can easily do so by loading up on short-term bonds, avoiding real estate, and buying shares of the best commodity producers like Suncor Energy.

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nelsonpsmith