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Advisors build strategies to counter high interest rates

by Cynthia Harrington

Advisors and investors were whipsawed with the markets as Treasury prices plummeted and rates jumped in recent weeks. After falling all the way to 3.07 percent on June 13, U.S. 10-year yields soared to 4.57 percent. The rapid moves forced the question of whether a new investing phase had begun or if this was just a spike in the gradual downward trend of rates.

"We were surprised at how quick the treasuries declined," said Kacy Gott, CPA, CFP, of Kochis, Fitz, Tracy, Fitzhugh & Gott Inc., in San Francisco. "But it was probably people second-guessing the Fed. And when they didn't do what was expected, investors had to move."

Many had anticipated rising rates. Rates had declined and there was little room left on the downside. "For some time, we had expected a change and had moved clients into shorter bonds and bond funds," said Gott. "However, most of the switching was for new clients that had come in with 10-year bonds. We had finally convinced them to sell and take their gains."

In general, CPA advisors are not responding to the shifting environment. Most are still committed to long-term investing according to a modern portfolio theory of an optimal mix of risk and return to meet a client's goals.

Phyllis Bernstein, CPA, of Phyllis Bernstein Consulting Inc., in New York, speaks often to CPA advisors nationwide. "I'm still hearing advisors who believe in asset allocation and are sticking with it, despite the tax law changes or higher interest rates," she said. "Some are shifting retirement assets to respond to new tax laws but they're still saying their clients need diversification across certain asset classes."

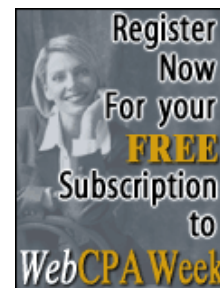
The expectation for higher rates is built into some bond asset class strategies. For instance, laddered bond portfolios invest portions in ever-longer maturities. As each portion matures, it is reinvested at the prevailing interest rates. "We are still committed to our laddered strategies," said Gott. "But we did convince clients not to go out the seven or eight years again on the long end with bonds maturing this year."

But not all CPAs are staying put. One Florida advisor is throwing out the old models in favor of strategies that respond to changing conditions. Jeff Diercks, CPA, of InTrust Advisors, in Tampa, Fla., shifted from the focus on diversification and tax efficiency. "In this environment, we feel we must be very nimble and we must trade," said Diercks. "Our goal now is to make profits not be diversified. Otherwise, we'll get to the end of this secular bear market and not have very good returns."

Diercks brought in a short-term strategy of trading mutual funds. The strategy originates from purchased newsletters, and Diercks built a customized portfolio based on additional parameters. "I also wanted to verify the performance numbers, so I back-tested the trades for three years," he said.

InTrust is moving assets into hedge funds as well as into other trading-oriented strategies. Its client base is made up of a few very wealthy families, as well as a few other clients that seek family-office types of services. "We are as high as 80 percent in hedge funds for our most wealthy clients, and average 30 percent to 40 percent in alternative investments," said Diercks. "We're getting to where we manage less of the whole pie in-house."

The speed of the interest rate increase caught Diercks offguard, as well. "We're watching for trades on interest rates but we still expect a low-rate

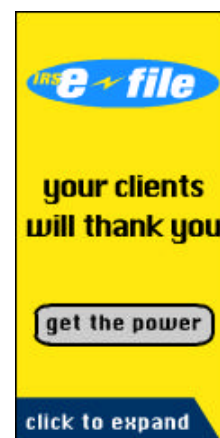


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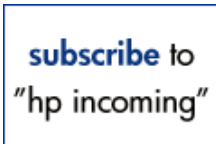
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environment overall," he said.

Speeding markets don't always signal a change in trend. "We don't expect a huge run-up from here in bonds," said Gott. "But we do hope rates go back up. Higher rates will bode well for the economy as a whole and equity returns, as well."

Since higher interest rates often are the Fed's response to inflation expectations, does the bond market move predict a return to inflation? No, said Gott. "This move isn't a threat of a return to higher inflation," he said. "Just six weeks ago, we were worried about deflation, and we're not going to switch our brains to start worrying about inflation."

"But we do hope that inflation returns," he added. "That will mean the economy is back on solid footing, which is a good situation for all of us and for our clients."

Most agree that the recent market move was too far, too fast. "This is a horrible environment for us. Rates moved too fast and now we have to worry about compression in the price-to-earnings ratios on stocks and a drop in equity prices," said Diercks.

Even though cash might be an attractive option right now, advisors need to find the way to add value. Diercks is watching the 10- and 30-year Treasury yield spread for the opportunity to trade bonds again. He said that there is an opportunity to profit from volatility in interest rates by using one of the mutual funds offering an inverse interest rate strategy from ProFunds, or one issued by Rydex.

Both inverse interest rate funds use the most recently issued 30-year Treasury as their bogey, which means that the funds are designed for maximum movement in response to rising rates. Since the Fed quit issuing the long bond two years ago, the most recently issued 30-year is the 2/31 bond.

Both funds profited from the recent move.

"It's not hard to explain our shift in philosophy to clients. When it comes to making money, they understand when we talk profits," said Diercks.

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