



MEGAN DORN, EA, CLTC, CFP®
Dorn Wealth Management

8500 Greenway Blvd
Suite 101
Middleton, WI 53562

(608)960-7273

Megan@dornwealthmanagement.com
www.dornwealthmanagement.com



How Rising Interest Rates Can Affect Your Financial Plans

By Elaine Floyd, CFP®

Whether you are managing debt, investing assets, or developing an estate plan, changes in interest rates represent an excellent opportunity to review your financial plan and consider new strategies designed to capitalize on changing conditions.

Calling the direction of interest rates has always been an iffy proposition. In many cases, even the experts disagree. But when the economy is in recovery and rates are inching up, it may be time to plan a new strategy. Here are some ways you can tweak your financial plans to take advantage of—or lessen the sting of—higher interest rates.

LIABILITY MANAGEMENT

Because debt is the area most directly and most negatively affected by a rise in interest rates, start by reviewing any debt portfolios. Look at credit card debt, mortgage debt (on one or two properties), home equity loans or lines of credit, and auto loans. Check to see if any adjustments need to be made to either pay down debt or switch to a less costly form of debt.

- **Credit card debt.** According to Bankrate, variable-rate cards tied to the prime rate move in direct response to Fed interest rate action. Fixed-rate cards are less volatile, but they are not a haven from higher rates because issuers can—and will—raise the rate.

Check your credit card bills to see what interest rate you are being charged and how much the debt is costing you each month in dollars and cents. Options for lowering credit card costs include negotiating for a lower rate or paying off the debt with available assets or with proceeds from another loan, such as a home equity loan, a lower-interest credit card, or even a loan from family members.

- **Home mortgage.** If you have a fixed mortgage, you can sit tight and keep making your regular mortgage payments. Although accelerating payments to pay off the mortgage faster may fit with your personal financial goals, this is generally a declining-rate strategy, not one undertaken in anticipation of rising rates.

If you have an adjustable-rate mortgage (ARM), on the other hand, you have a decision to make: Should you switch to a fixed-rate mortgage before rates go higher, or stick with their ARM (depending on what the spread is)? The ARM can be a better deal if you don't plan to stay in the home for more than a few years.

- **Home equity loans and lines of credit.** Here you're dealing with the fixed vs. adjustable question again. If you have a fixed-rate home equity loan you can sit tight. If you have small, short-term loans or lines of credit tied to the prime rate, you may want to lock in a fixed-rate loan before rates go much higher or you plan to pay off the loan fairly soon.
- **Auto loans and leases.** According to Bankrate, auto loans typically reflect rate increases before the Fed's move, responding to yields on Treasury securities. If you are thinking of buying a car, you may want to do it when financing incentives offered by dealers are most attractive.
- **401(k) loans.** Rates on 401(k) loans are usually tied to the prime rate, so it is not possible to lock in a rate on these loans. Better to pay them off, perhaps taking out a fixed-rate home equity loan to do so.

ASSET MANAGEMENT

Savers typically rejoice at the prospect of rising interest rates, but use caution if you are thinking of locking in higher yields while rates are still rising.

- **Ladder maturities.** Laddering CDs or short-term fixed-income securities is a classic strategy when rates are in flux and you don't want to commit too much of your portfolio to one particular scenario. If rates jump, you've always got something coming due that can be reinvested at the higher rate. When rates are rising, you want to keep the ladder fairly short—say, up to three years—gradually lengthening the ladder as rates continue to rise.
- **Special situations.** Believe it or not, some bonds hold their value when interest rates go up. This can happen when something other than interest rates exerts a greater influence on the bond's price, such as when a bond's credit quality improves.

By searching out special situations (or finding professional money managers who have the time and resources to thoroughly analyze the bond market), you may be able to achieve long-term yields with minimal interest-rate risk, but since this strategy involves buying bonds of lower quality in the hope that the fortunes of the issuer improve, there's still a good deal of risk involved. Definitely discuss a special situations strategy with an investment professional.

ESTATE PLANNING

Certain estate planning strategies are worth more if they are implemented when rates are low and the strategies are appropriate for your situation. It is also a good idea to check with your tax advisor before making any irrevocable decisions:

- **Grantor-retained annuity trust (GRAT).** A GRAT is used to shift assets to family members before they appreciate in value. The grantor places assets in trust and receives a portion of the assets each year in the form of an annuity. A gift tax is triggered at the time the assets are transferred into the trust, with the value of the gift being the fair market value of the assets minus the grantor's retained interest, which is the present value of all of the annuity payments over the term of the trust.

Both the annuity payments and the present-value calculation are tied to the 7520 rate, which changes every month based on Treasury bond yields. The lower the 7520 rate, the less income the grantor is forced to accept, which means more assets remain in the trust for heirs.

Also, the lower the initial interest rate when the present value of the income stream is established, the higher the grantor's retained interest will be, thus lowering the value of the gift for gift-tax purposes.

- **Charitable lead trust (CLT).** With a CLT, a charity gets the use of the assets in the form of an annuity during the donor's lifetime. After death, the assets go to the donor's heirs. The amount of the annuity going to the charity must at least match the 7520 rate, with any appreciation over that rate going to the heirs. Therefore, the lower the 7520 rate, the more may potentially be left to heirs tax-free. However, as the 7520 rate rises, the more the assets will need to earn to overcome the "hurdle" rate.

The following strategies are worth more when interest rates are high. You may therefore want

to wait until rates have finished climbing before implementing them.

- **Charitable remainder trust (CRT).** The CRT is the reverse of the CLT. A donor places assets in trust and receives income from the trust for a period of time, after which the remaining amount goes to a designated charity. At the time the assets are placed in trust, the donor receives a charitable tax deduction for the amount that is expected to go to charity. The higher the interest rate is, the more the assets are expected to earn, which means the larger the tax-deductible gift to charity will be.
- **Qualified personal residence trust (QPRT).** A QPRT is designed to remove an appreciating home from an estate while allowing the donors to continue living in it. The value of the taxable gift is established when the house is put into the trust. The higher the interest rate is when the trust is established, and the longer the term of the trust, the lower the taxable gift will be.

Elaine Floyd, CFP® is Director of Retirement and Life Planning for Horseshoemouth, LLC, where she helps people understand the practical and technical aspects of retirement income planning.