Impact of Changes in Interest Rates on Investment

When we hear the term, '*interest rate'*, we immediately think of the annual amount charged on our loans and credit cards. Interest rate is not only the cost of borrowing but it also refers to the amount earned on savings and investments. In this final article in our five-part series on competent investment management, we look at the impact of fluctuations in interest rates on the value of investments. Before so doing, however, its is important to understand the role of the Central Bank of Trinidad and Tobago ("the Central Bank") and its monetary policy in influencing domestic interest rates.

Pursuant to Section 3 of the Central Bank Act Chapter 79:02, Act 23 of 1964, the Central Bank *"shall have at its purpose the promotion of such monetary credit and exchange conditions as are most favourable to the development of the economy of Trinidad and Tobago"*. The Central Bank is responsible for maintaining monetary stability. Towards this end, the Central Bank, since mid-2002, has been utilising the repo rate to promote financial conditions that are in keeping with the country's economic objectives. The repo rate is the rate the Central Bank charges commercial banks for borrowing funds on an overnight basis. Changes in the repo rate are an indication of the likely direction of short-term interest rates. At its September 2021 meeting, the Central Bank's Monetary Policy Committee decided to maintain the repo rate at 3.50%.

Interest rates are not only affected by the Central Bank's repo rate but also, for example, by the demand and supply for credit as well as inflation expectations. An increase in the demand for credit or money will raise the level of interest rates while a decrease in demand will lower the level of interest rates. Conversely, an increase in the supply of credit or money will reduce the level of interest rates while a decrease in the supply of money will increase the level of interest rates. If consumers and businesses are expecting a general increase in prices, the

level of interest rates is likely to rise. This occurs as lenders will demand greater compensation for the expected erosion of their purchasing power given the increase in the inflation rate.

Impact on Bonds

Interest rates and bond prices are inversely related. When interest rates fall, bond prices rise and vice versa. In a rising interest rate environment, the coupon rates[1] for newly issued bonds tend to exceed the prevailing level of interest rates in the market. These newly issued bonds become more attractive to investors. Investors will therefore want to sell the previously issued bonds, resulting in a decline in the prices for existing bonds.

Rising interest rates pose a risk to bond investors. If you need to sell a bond prior to its maturity date and interest rates have risen, you may end up selling the bond for less than your purchase price. If you hold the bond until its maturity date, however, you will receive the initial amount invested plus the agreed coupon amounts, once the bond issuer does not default.

Let's look at an example. Say in 2018, you invested $10,000 in a 5-year bond that pays an annual coupon rate of 2.50%. Interest rates have since increased in the market and the bond is currently priced at $9,430. Table 1. shows your total return on investment.

Table 1: Total Investment Return

Initial Bond Value	$10,000	
Current Bond Value	$9,430	
Decrease in Bond Value		-$570
Interest earned over 3 years		$750
Total Investment Return		**$180**

If interest rates had actually decreased and the price of the bond rose to $10,160, the total return on your investment would be $910.

Impact on Stocks

Unlike bonds, interest rate changes do not directly impact share or stock prices. When interest rates rise, the cost of borrowing for companies and consumers increase. As

[1] The coupon rate is the annual income an investor can expect to receive while holding a particular bond

consumers have less money to spend and companies have higher interest payments to make, this may negatively impact company earnings and accordingly their share prices.

Impact on Other Investments

Fluctuations in interest rates impact the value of the underlying securities (bonds, equities, etc.) of a mutual fund and ultimately the net asset value (NAV) of these funds. In the case of fixed NAV funds, the mutual fund manager will strive to ensure that the NAV remains constant despite fluctuations in the underlying securities' values, however, the return on the fund may reduce or fluctuate.

Interest rates can affect your investments in different ways. It is therefore important to remain focus on your investment goals and consult with an investment adviser/broker/dealer that is registered with the Trinidad and Tobago Securities and Exchange Commission (TTSEC) who can help you construct a diversified portfolio that can weather fluctuations in interest rates.

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You may also visit our Investor Education website at **www.investucatett.com** or connect with us via any of our social media handles:

Published Article – Business Express Newspaper
November 30th, 2021