

ADVISOR

HOW WE LIVE **NOW**

Juggling kids, parents and busy careers—while finding time for what matters most.

The pressures and joys of **THE NEW AMERICAN FAMILY**

TURNING POINTS

How to Prepare for
Life's Defining Moments

GIVING BOOM(ers)

The Generation
Changing the Way It
Changes the World

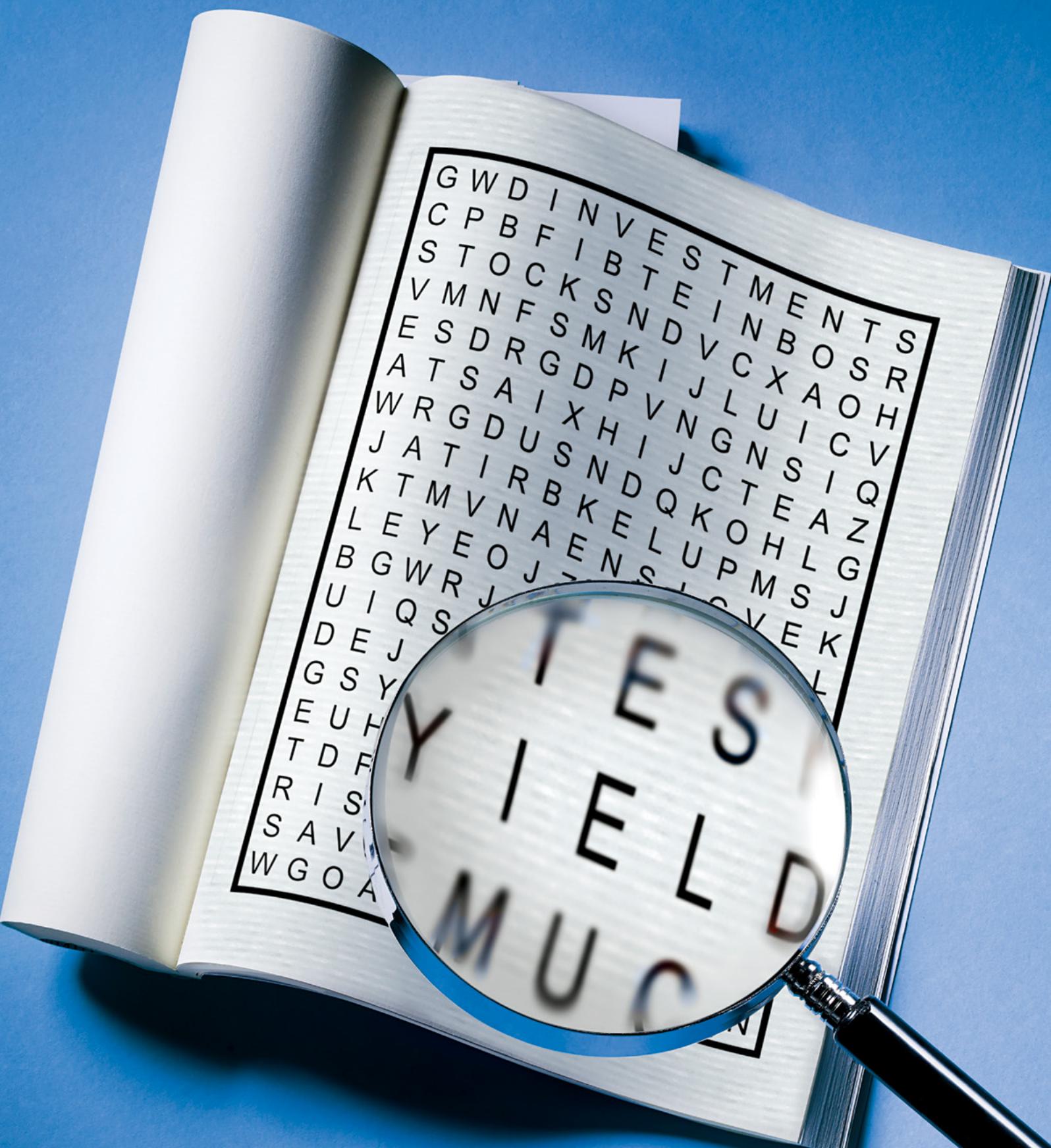


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PLUS: MARKET VOLATILITY Your Strategy to Manage the Big Swings **PAGE 3**

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THE NEED FOR *Yield* ISN'T CHANGING. BUT WAYS TO FIND IT ARE

A return to higher interest rates would mark a significant turning point for investors. Here are ways you can look for portfolio income, at whatever stage of life you're in

by CJ Prince

FOR NEARLY A DECADE, with the Federal Reserve keeping interest rates at historic lows, the only way to get a reasonable level of income from your stocks and bonds—a solid *yield*—has been to accept heightened risk.

Now expectations are that the Federal Reserve will begin to normalize rates, ever so gradually, over the next year. "The Fed has decided we're finally getting where we need to be in terms of the economic recovery," says Ethan Harris, co-head of Global Economics Research at BofA Merrill Lynch Global Research. However, ongoing volatility and uncertainty in the global economy have made the Fed very cautious; a widely expected rate increase in September 2015 didn't happen for those reasons.

In other words, don't expect a quick or dramatic rise. The Fed will most likely start with a modest increase in the federal funds rate—the interest banks charge one another for overnight loans—of a quarter of a percentage point, and further increases will come slowly, Harris says. Getting back to more typical rates will likely happen over years, not months. »»



SO, WHAT DOES IT ALL MEAN FOR ME NOW?

Because of this gradual rise, drawing steady income from your portfolio—for retirement, to pay college bills or to support a business, among other purposes—will continue to be a challenge. But the equity and fixed income strategies you can consider have already begun to shift.

“Even a very slow increase in interest rates will likely mark a major change for investors,” says Karin Kimbrough, head of Macro and Economic Policy at Merrill Lynch Wealth Management. As you move into the new year, it’s a good idea to review how much your bond portfolio might have appreciated in value, as well as payments from bond interest or stock dividends, and how all of those factors might change as rates rise.

What’s crucial now, as always, is to find a mix of investments tailored to your particular goals, Kimbrough says—and what works for you may not be appropriate for someone else. Here, our experts suggest various strategies to

consider, depending on your priorities and where you are in life.

WILL MY ASSETS LAST IN RETIREMENT?

Nowadays, as people live longer and longer, one of the chief concerns of older Americans is making sure they won’t outlive their money. And retirees, perhaps most of all, have felt the pinch of lower rates, with their savings and fixed income portfolios earning next to nothing. That challenge should ease a bit as rates rise—but retirees may need to review and adjust their existing asset allocations. (For insights on how bonds and stocks respond differently to rising rates, see “Stocks or Bonds: What Happens When Rates Rise?” below.)

“Someone at age 75 or so may not be able to take as much investment risk,” Kimbrough says. Still, you’ll need your holdings to grow enough to outpace inflation, which is currently low but could rise along with interest rates. To help maintain income while you pursue growth, Kimbrough suggests the follow-

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ing approach: Consider dividing your assets into two buckets—one for guaranteed income-type investments and the other for more aggressive, longer-term investments. For the first bucket, you could purchase an immediate annuity that is designed to provide guaranteed monthly income for life. Most immediate annuities can be set up to also provide income to a surviving spouse.

Just be aware that those potential benefits come with some risks—for example, that unless you buy inflation protection your buying power could wane, you might die too soon to recoup your investment, or the insurer promising your payments could fail.

Meanwhile, for the other bucket, you might consider investing your remain-

STOCKS OR BONDS: WHAT HAPPENS WHEN RATES RISE?

Understanding income-producing investments—and how they might behave as interest rates rise—can help guide your search for income



Karin Kimbrough,
head of Macro
and Economic
Policy at
Merrill Lynch
Wealth
Management

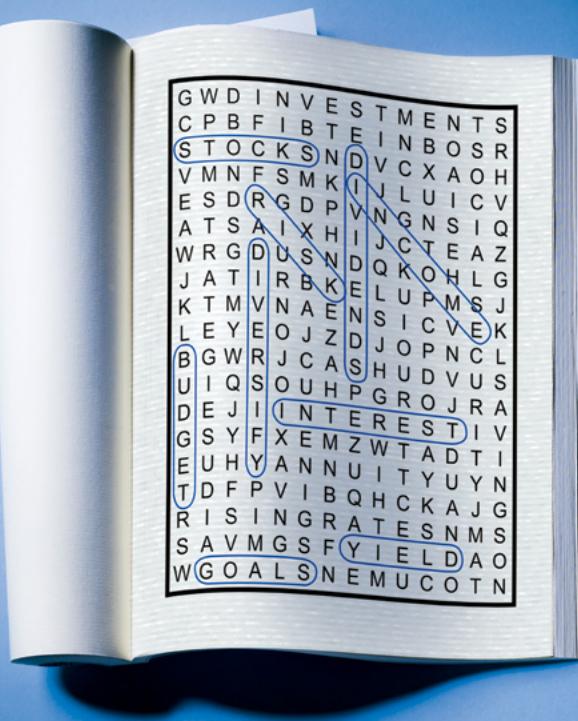
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lthough there are no specific rules about how bonds and dividend-paying stocks respond to rising interest rates, there are some broad tendencies you may want to consider.

With bonds, the “coupon rate” is the interest rate that an issuer uses to calculate regular interest payments to investors. The longer the term of a bond, the higher the coupon is likely to be; you’re paid more to wait longer to get your principal back. Higher risk, too, affects the coupon, with high-yield bonds from less solid companies offering more generous interest payments than you’ll get from higher-rated corporations or from U.S. Treasury bonds.

While coupon rates don’t change during the life of a bond, bond prices themselves do fluctuate as bonds are bought and sold on secondary markets. And changes in prevailing interest rates will affect the value of bonds in your portfolio. If rates are on the rise, newly issued bonds with higher rates will be more appealing than older bonds paying less. That can reduce demand for your existing bonds and push down their resale prices. When rates are rising, bonds with longer maturities tend to suffer most because they lock investors into lower rates for extended periods.

Meanwhile, dividend stocks are less directly affected when interest rates rise, which has historically happened when the economy is growing. But the kinds of companies that thrive during an economic expansion are also the ones most likely to increase their dividends. There isn’t a single strategy that will work for everyone. “It’s important to consider the risks and potential rewards of a variety of assets and take an approach that emphasizes total return,” notes Karin Kimbrough, head of Macro and Economic Policy at Merrill Lynch Wealth Management.



“Even a very slow increase in interest rates will likely mark a major change for investors.”

KARIN KIMBROUGH
Head of Macro and Economic Policy,
Merrill Lynch Wealth Management

ing funds in a diversified but more aggressively allocated portfolio that you don't plan to touch for the next 15 years. Potentially, those assets can grow long-term while you spend the income from your immediate annuity. This strategy may not work for those who are near retirement or won't accept the additional risks that are associated with more aggressive investments.

Another option is to consider blue-chip stocks that have a history of paying dividends, or quarterly payments to stockholders, which are currently higher than the yields on many bonds. To complement that, you could go with a fixed income portfolio concentrated in investments that currently do not have high yields—such as U.S. Treasuries, municipal bonds and certificates of deposit (CDs)—but are likely to provide more generous payments years from now when interest rates are potentially higher.

WHAT IF I HAVE TIME TO INVEST MORE AGGRESSIVELY?

In most cases, people who aren't in or near retirement may be able to pursue a more flexible strategy. But different age groups may have different needs.

A young entrepreneur in her thirties,

for example, might need portfolio income to supplement the paycheck from a fledgling business. A fiftysomething parent with kids in college, on the other hand, may require additional income to cover ongoing tuition and expenses.

If you do have several decades to invest and no immediate need to draw reliable income, you may want to keep many of your holdings in stocks. When interest rates trend higher, an option may be to buy stock in historically solid, growth companies that have paid dividends—and that could increase payouts in the future. According to the U.S. Equity Strategy team at BofA Merrill Lynch Global Research, the current choices in U.S. equities are likely large, high-quality companies, particularly in technology, industrials and energy.

However, a well-diversified bond portfolio can also play an important role in a long-term investment strategy. High-quality, investment-grade corporate bonds can offer above-average stability and potential steady income. Those looking for higher income who can accept high risks may also want to include riskier high-yield corporate bonds, especially as slowly rising rates

could lead to better coupon (interest) rates for those riskier investments.

But keep in mind that companies that issue high-yield bonds typically don't fare as well when rates rise, according to Martin Mauro, fixed income strategist at BofA Merrill Lynch Global Research.

If you're in a higher tax bracket, you may also want to add high-quality municipal bonds to your investment mix, and might consider munis with longer maturities. “Those bonds, in our view, wouldn't suffer that much if rates rise only a little bit,” says Christopher J. Wolfe, chief investment officer for Portfolio Solutions, Private Banking and Investment Group & Institutional at Merrill Lynch Wealth Management. You could also hedge the interest-rate risk of your bonds by building a bond ladder that uses cash from maturing bonds to reinvest in new bonds that could be offering higher rates.

Another option to consider, says Kimbrough, is to “sell some of your stocks that have grown in value over time and take your earnings as cash.” The proceeds could go toward helping pay for current expenses or re-investing in more attractively valued investments.

Meanwhile, events in the markets may continue to cause some uncertainty. As the Fed begins a likely path of slowly but steadily raising interest rates, volatility could remain elevated. This makes it more important than ever to consider what your short- and long-term goals are and to develop a strategy that helps you stay on track. 

See back cover for fixed income disclosures.

3 QUESTIONS TO ASK YOUR ADVISOR

1. Can I tell which stocks are likely to increase their dividends over time?
2. Could a bond ladder be an appropriate strategy for me, especially as interest rates rise?
3. Would purchasing an immediate annuity be a good step at my current stage of life?



A LEGACY OF CARING

Looking for a way to make a measurable and lasting difference in the treatment of childhood diseases, Walter and Idun Berry (below) turned to Merrill Lynch Financial Advisors Robert and Christopher Demmler (middle right).

With the Demmlers' help, in 1990 the Berrys founded the Walter V. and Idun Berry Foundation to fund pediatric health research. Today, the foundation continues to support the cause that its founders were so passionate about.

So far it has supported nearly 100 researchers—people like former Berry Fellows Kari Nadeau (top right) and Ravi Majeti (bottom right), who are making progress in the treatment of childhood cancers, asthma and allergies.



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