Stern Advice: Borrow now and other ways to prep for rising rates

By Linda Stern
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May 29 (Reuters) - Don't look now, but interest rates have started to rise.

The 30-year fixed rate mortgage, now at 3.9 percent, bottomed out at 3.5 percent in December 2012, according to Bankrate.com. Yields on 10-year Treasury bonds, at 2.15 percent, are at 13-month highs.

Much of this is in anticipation of a stronger economy and the eventual withdrawal of the Federal Reserve's bond-buying and rate-lowering stimulus program. When that happens, short-term rates on instruments like money market mutual funds and credit cards are likely to go up, too.

To be sure, nobody knows when the Fed will stop or when sizable and sustainable interest-rate increases will take hold.

"While this seems blindingly obvious, nobody would have thought that Japan would have had two decades of deflation," says David Hultstrom, a financial adviser with Financial Architects in Woodstock, Georgia. "It is not a slam dunk."

But the pros are already taking what Albion Financial Group market strategist Jason Ware calls "the prudent approach" and positioning themselves for the big rate increases that might be five weeks - or five years - in the offing.

You should, too. When rates rise, the value of your bonds and bond funds will fall, and you may find yourself paying more than you can afford to cover your mortgage, auto loan and credit card bills. Here is how to get ready for the next rate era.

-- Borrow big, now. "If you are trying to hedge inflation or higher rates, the best thing you can do is get a 30-year fixed-rate mortgage at a low rate," Hultstrom says. Rates now have inched off of their December 2012 lows, but still are very close to record low levels. If you have a home and have not already refinanced your mortgage, consider doing so as soon as possible. Unless you are moving soon, borrow for the long haul, and skip the variable-rate loan.

-- Lock in a low rate for your credit cards. Most credit card rates vary monthly, so once short-term rates start to rise, the rates on your balances will rise, too. But card issuers have been aggressive this year to lure new customers with zero interest balance transfers lasting as long as 18 months. Even with transfer fees, that lets you lock in annual rates as low as 3 percent for more than a year. You can find the latest deals on web comparison sites like NerdWallet ().

-- Accept low, low returns to stay safe and liquid. Money market mutual funds and bank money market deposit accounts are barely paying any discernable interest at all - the latter are averaging a record low of 0.11 percent a year. But these investments are called "cash" for a reason - they are as safe as $20 bills stuffed under your mattress and easier to deploy when you think bond yields have gone high enough - or stock prices low enough - for you to invest.

-- Stay short. Don't tie money up in long-term bonds and the funds that focus on them now, Ware says. Shorter-term bonds and bond funds with expected maturities under five years will let you squeeze out some additional income without getting slammed when rates rise by a lot. For example, if interest rates rise 1 percent, a 10-year note can be expected to lose 10 percent of its value, while a 2-year note would lose 2 percent of its value.

-- Beware of TIPs. Treasury inflation-protected securities and the mutual funds that buy them will protect your investment from the ravages of inflation. But they will not protect you in a situation where rates rise more rapidly than consumer inflation does - they may actually fall in value faster than fixed-rate bonds would in that circumstance. Last month, consumer prices actually fell 0.4 percent on a seasonally adjusted basis. That is not a good sign for TIPs holders.

-- Consider alternatives. Advisers are recommending a variety of other investments to their clients now. Real estate investment trusts (REITs) work in a rising rate environment, because property owners can raise rents faster than their own costs are likely to rise, Hultstrom says. He also is interested in mutual funds that invest in international bonds (which typically have higher yields than U.S. bonds) but that hedge the currency risk. Ware, who is based in Salt Lake City, recommends floating-rate funds that are what they sound like: Packages of bank loans that have adjustable interest rates. That way if rates go up, you will get a piece of that action as it happens.

-- Prepare to wait. Even if the Fed acts quickly, it's going to be a while before retirees can again celebrate getting solid returns on their bank certificates of deposit.

"In five years will rates be higher? Probably," Ware says. "In five months? I don't know."

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