MAKING SENSE of BONDS

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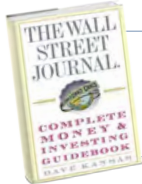
Making Sense of BONDS



The following is adapted from
*"**The Complete Money and Investing Guidebook**"* by Dave Kansas.

Many of my clients own bonds, and as the stock market becomes more and more volatile, more clients ask questions about owning bonds for a larger portion of their portfolio. Interestingly enough, I have found that most people I meet know very little about bonds, and for the most part, what they know is not necessarily true. The common characteristic people I meet think of when they think of bonds is that they're safer than stocks. They can be. But they can also be riskier.

Let's go back to basics and dive under the hood of the Bond as an investment. Bonds are quite different than stocks. Whereas a stock is a unit of ownership in a corporation, a bond is a form of debt. Typically bonds are issued by companies, cities, schools, and governments as loans, or IOUs, but you serve as the bank. You loan them your money and they promise to pay you back in full at a certain date in the future, with regular interest payments. A company may sell bonds to purchase new computers or build a new facility. A school may sell bonds to raise money to build a new gymnasium. A city may sell bonds to raise money to build a new park. A state may sell bonds to repair highways. The federal government issues bonds to finance its increasing debt load.

Bonds tend to attract more conservative investors because of the steady stream of interest income they earn, as well as stock investors who flock to the perceived safety of bonds when the stock market become too volatile. Despite the regular income payments investors receive through owning bonds, not all bonds are "risk-free". Some bonds can even carry more substantia risk than stocks.

Risk in owning bonds is not very well understood by most investors. Risk in owning bonds comes in a few different varieties; credit risk, interest rate risk, call risk, reinvestment risk and inflation risk.

Risk in owning bonds comes in a few different varieties;

- RISK #1 Credit Risk
- RISK #2 Interest Rate Risk
- RISK #3 Call Risk
- RISK #4 Reinvestment Risk
- RISK #5 Inflation Risk

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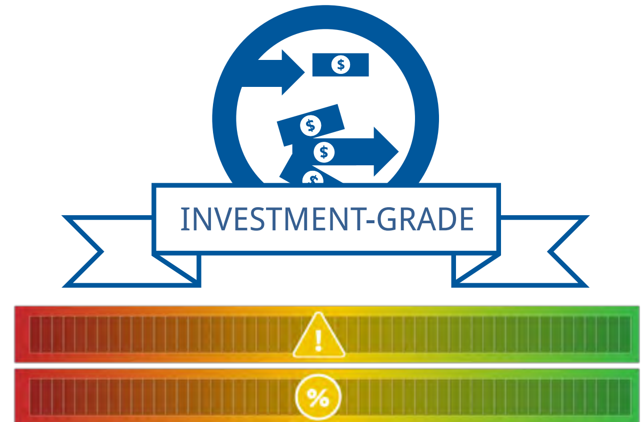
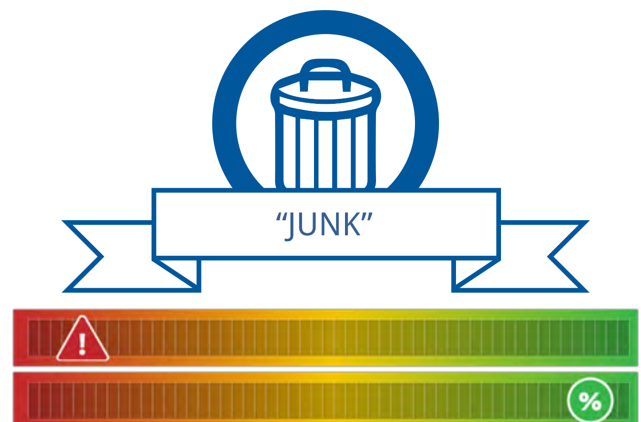
Risk #1: Credit Risk

What is the likelihood the bond issuer will make good on its obligation to pay you back upon the stated maturity of the bond, as well as make interest payments each quarter or month? Less credit-worthy issuers will pay a higher yield, or interest rate. That's why the riskiest issuers offer what's called high-yield or "junk" bonds. They must pay you a higher interest rate to offset the higher risk that they may default on their loan to you. Those at the opposite end of the spectrum, or those with the best histories of repaying debts, are deemed investment-grade bonds, and generally pay a lower interest rate because you will likely not need to worry about a default..

The safest bonds from the standpoint of credit risk are those issued by the U.S. government, known as Treasuries. These bonds are backed by the "full faith and credit" of the U.S. and are deemed virtually risk-free. The US has the ability to raise taxes and/or issue new debt to pay their existing debts, something most entities do not have the power to do. As such, a Treasury bond will pay a lower yield then a bond issued by a corporation or a school district.





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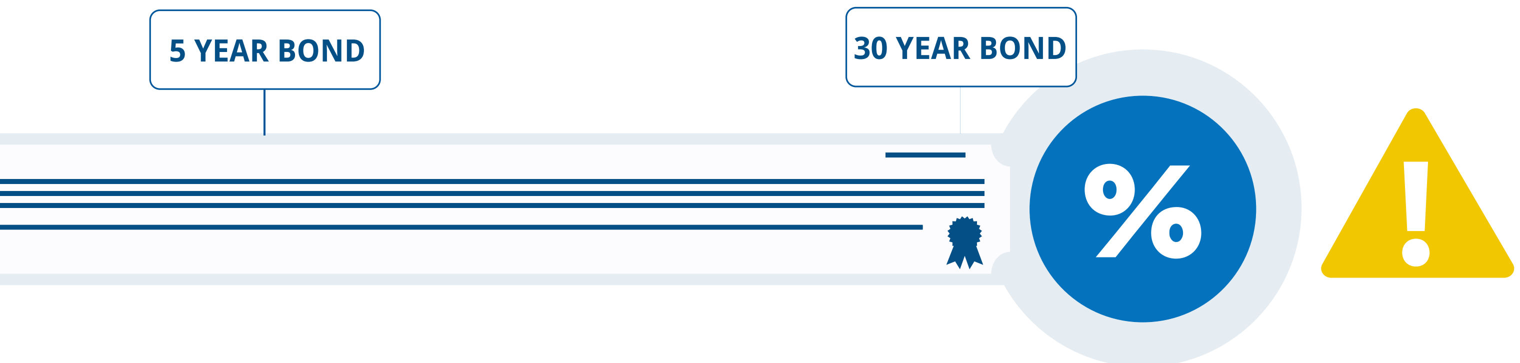

Risk #2: Interest Rate Risk

The longer the bond, the higher the interest rate. Bonds that mature in 30 years tend to pay more interest than bonds that mature in 5 years. You're being paid more for keeping your money tied up for a longer period of time.

However it is important to know that owning a longer bond (20 or 30 years) exposes you to greater interest rate risk. Interest rates have the single largest impact on daily bond prices. As interest rates rise, bond prices fall. When rates climb, new bonds are issued at the higher rate, making existing bonds with lower rates less valuable. Of course, if you hold onto your bond until maturity, it doesn't matter how much the price fluctuates because the bond issuer agreed to pay you back the face amount (amount you invested) of the bond when it matures. But if you need to sell your bond on the secondary market – before it matures – you could get less than your original investment back if interest rates rise and your bond becomes less valuable. The farther away your bond is from maturing, the more sensitive its price will be if interest rates fluctuate.

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Risk #3: Call Risk

Some bonds have a built in safety feature for bond issuers, referred to as "call protection". It gives them an ability to "call" their bond away from you and return your money. If interest rates drop, this call feature allows issuers to basically erase their current debt, and reissue new bonds at a lower interest rate. It's like having the option to refinance your debt.

The reason this poses a risk to investors is because many bond holders create substantial portion of their retirement income based on the interest they receive from their bond holdings. If a retiree has a large bond position called away, and he must now buy lower paying bonds, it could have a drastic effect on the amount of retirement income one receives.

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Risk #4 & Risk #5:
Reinvestment Risk & Inflation Risk

Similar to call risk, reinvestment risk can hurt bond investors significantly if interest rates drop dramatically. Back in 1981, when then-Federal Reserve Chairman, Paul Volcker, was battling to contain hyperinflation, 30-year bond yields topped 15%. Twenty-seven years later, during the crisis of 2008, the 30-year yield plummeted to an all-time low of 2.55%.

Imagine if you had $1,000,000 invested in 30-year bonds in 1981. You would have been earning nearly $150,000 each year in interest payments. That bond matured in 2011 and if you were to renew your 30-year bond, your interest payment would drop to $25,500. Not only did your income drop substantially, but so did the amount of purchasing power your $1,000,000 had. In 1981, a postage stamp cost $0.18. By 2011, a stamp cost increased by more than double, to $0.44. Your million today is worth about half of what it was worth in 1981, meaning it will buy you about ½ of what it could have bought you 30 years ago.

Now that we have reviewed some of the risks associated with investing in bonds, let's compare how different types of bonds are effected by each risk

Investment Risk Chart

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Investment Risk Levels

		Risk #1	Risk #2	Risk #3	Risk #4	Risk #5
INVESTMENT TYPE		Credit	Interest Rate	Call	Reinvestment	Inflation
TREASURIES	Issued by US government					
	Bills Issued in maturities of less than 1 year	Low	Low	Low	Low	High
	Notes Issued in maturities between 1-5 years	Low	Moderate	Low	Moderate	High
	Bonds Issued in maturities between 5-30 years	Low	High	Low	High	High
	TIPS Treasury Inflation Protection Securities	Low	Moderate	Low	Moderate	Moderate
SAVINGS BONDS	Issued by banks					
	EE	Low	Low	Low	High	High
	Series 1	Low	Low	Low	Moderate	Moderate
AGENCIES	Issued by US govt agencies	Low	Moderate	Moderate	High	High
MUNICIPALS	Issued by state & local government agencies					
	General Obligation Backed by full faith and credit of underlying municipality	Moderate	Moderate	High	Moderate	Moderate
	Revenue Backed by underlying revenue stream. Ex, school taxes, highway toll collection	Low	Moderate	High	Moderate	Moderate
	Intermediate 1-9 years	Moderate	Moderate	Moderate	Moderate	High
	Long Term 9 years or more	Moderate	High	High	High	Moderate
	Insured	Low	Moderate	High	High	High
CORPORATE	Issued by public & private corporations					
	Commercial Paper	Low	Low	Low	High	High
	Investment Grade Rated BBB or higher	Moderate	High	Moderate	Moderate	Moderate
	High Yield / Junk Rated under BBB	High	Moderate	Moderate	Moderate	Low

Like all possible investment tools, bonds may have a place inside a portfolio to provide everything from current income to appreciation potential. However use caution when purchasing bonds and if you're a novice investor, I recommend you not go at it alone. Bond yields have been falling for nearly 30 years which means prices have been rising. Many experts believe the bond market is the next bubble to pop when rates begin to rise. And given that the bond market is considerably larger than the stock market, a bond bubble pop would be catastrophic. If you need some guidance, I recommend working with a local financial advisor in your community.

If you own bond funds inside your 401k and you would like our help figuring out if they're right for you, we'd be glad to assist.

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Matthew Grishman is the Co-Founder & Chief Marketing Officer of 401k Masters, LLC. He is also a Principal & Wealth Advisor at Gebhardt Group, Inc. Matthew has 19 years of experience guiding families, entrepreneurs, and athletes through the complexities of financial planning and living their life's true purpose.

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