



Investing in Bonds 101

In our experience, most of our clients have a much better understanding of stocks than they do of bonds - which is not too surprising when you consider that the stock market tends to attract more attention with its dramatic highs and lows, and the media focuses on that drama. However, bonds are an important part of prudently managed portfolios, and it's important that investors understand the fundamentals.

A bond is a debt instrument. In exchange for lending a company or a government (or in the case of a CD, a bank) your money, you are issued an IOU, or a bond, where the issuer promises to pay back the face value of that bond at a specific date, and promises to make regular interest payments along the way. Because the interest rate and face value are specified, or fixed, bonds are part of the fixed income asset class. Stocks, on the other hand, represent an ownership share in a company; there is no promise of a regular payment (a dividend) or a return of your principal; they are part of the equity asset class.

Equities (stocks) and fixed income (bonds) are two of the core asset classes in our managed portfolios. The stock positions are there for growth. Over the long term, stocks have provided much higher returns than bonds, but have also carried much greater volatility (uncertainty that any given period's return will be anything like the long term average rate of return). Since 1926, US large company stocks have returned an annual average of about 10%. Risk and reward go hand in hand in investing; the lower volatility of bonds means that the return has been lower -- intermediate-term government bonds returned an annual average of about 5% in the same period

One of the most important decisions we help every client make is the decision on how to allocate those two primary asset classes to meet his or her goals, within the constraints of his or her tolerance for risk, his or her time horizon for needing to spend from the portfolio, and his or her required rate of return. We would all love to earn the higher long term return of stocks, but most of us couldn't endure the volatility of a 100% stock portfolio. For example, if you held a portfolio with 75% in a broad US stock index and 25% in broad foreign index during the most recent bear market, your portfolio would have lost about 44% of its value between April 2000 and October 2002.

The fixed income allocation of your portfolio can serve to soften that kind of volatility in two ways: bond returns typically don't swing as wildly as stock returns, and bonds and stock returns are not perfectly correlated, so that a downturn in the stock market can sometimes be offset by an opposite movement in the bond market, and vice versa, making for a smoother ride over time.

One of the fundamental concepts to understand when investing in bonds is that bond values are very sensitive to changes in interest rates, and it is an inverse relationship: when interest rates go up, the value of bonds decreases, and when interest rates fall, bond prices rise.

Here's an example: Market interest rates are at 4%. You buy a newly issued \$10,000 bond with a 4% stated interest rate. Each year, you'll be paid \$400 in interest, and when the bond matures, you'll be paid \$10,000. However, if interest rates rise to 5%, a new investor would demand more than a 4% rate of return on your bond. To be attractive to a new purchaser, the price of your bond has to drop in today's market so that the same \$400 interest payment per year, and \$10,000 paid at maturity, represents a 5% rate of return.

How we invest in the bond market in the portfolios we manage depends on each client's risk tolerance, time horizon for needing funds from the portfolio, certainty of the size and timing of distribution needs, the tax status of the account, and the client's marginal tax bracket. Most of our clients have a mix of bond funds and individual bonds, as each serves a purpose in the portfolio.

For example, if a client is many years away from taking funds out of their portfolio, we may buy bond mutual funds. The value of the funds will rise and fall over multiple interest rate cycles; since the client isn't taking cash out of the portfolio, we're not concerned about that volatility. Along the way, the client will get market interest rates on the bonds in that fund.

Bond funds have several advantages: they are very liquid, we can buy and sell them in small quantities, they offer instant diversification in the bond market, and despite carrying an annual fee to the fund manager, can be well priced if the expense ratio is low.

If a client has specific cash needs from their portfolio in a specific time frame, we may buy individual bonds. Individual bonds have the distinct advantage of having a defined cash flow: at purchase, you know what your yield will be if you hold the bond until maturity, and can be unconcerned about the price movement of the bond along the way.

And for retired clients who are taking regular distributions from their portfolio to fund living expenses, we may buy individual bonds and ladder them (buy a series of bonds with increasing maturities, up to five years, spaced one year apart). In this way, we build a cushion of "safe money": each year, we have a bond maturing to fund the client's annual distribution should there be no stock market profits to take.

The bond market doesn't spend nearly as much time in the limelight as the stock market, but it's just as fundamental to the risk/reward profile of the portfolios we manage.

-- Therese Govern. Posted 2/15/07.