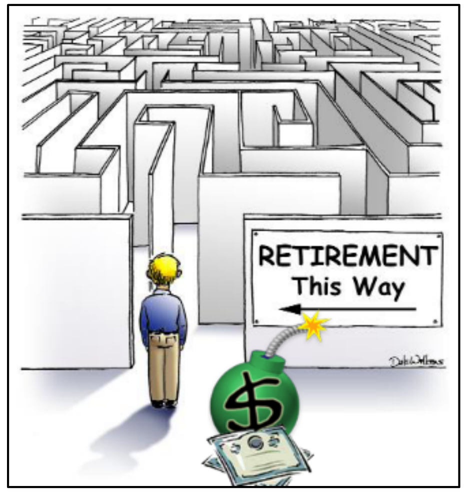
Bonds: Hold 'em or fold 'em?

Navigating the Retirement Maze



New definition of bonds: Financial instruments offering "return-less risk."

–Financial analyst

You can't pick up a business publication these days without reading prognostications concerning interest rates and their impact on bonds. If Janet Yellen so much as sneezes, the bond markets catch a cold. News headlines like "Bond Bubble?" permeate the financial press, leaving the average investor to worry about the potential time bombs in their portfolio.

Thus, many are questioning whether bonds belong in their investment portfolios at all. My answer, as it often is with investment issues: It depends… on your investment time frames and goals, and on the types of bond investments that you hold. I'll touch upon some pros and cons of bonds, as well as considerations for owning bonds going forward.

Why own bonds?

There are three main reasons for owning bonds: income, diversification, and safety. By definition, a bond is a contract between a borrower and a lender, where the former promises to pay interest to the latter for the term of the bond. Most bonds pay a fixed rate of interest, so for retirees looking for a predictable stream of income, bonds seem to fit the bill.

Second, most types of bonds have historically shown a low correlation to stocks, meaning that the two asset classes don't tend to rise and fall simultaneously. Thus, while the equity portion of your portfolio may be taking a nose dive, bonds could be balancing the loss with steady prices or even a gain. Diversification – holding a mix of asset classes – helps reduce portfolio volatility, and is one of the tenets of portfolio theory.

Third, bond prices typically don't fluctuate as much as those of equities, bringing some stability to your portfolio. There are some bonds that are quite volatile – think Puerto Rico and Greece – but most investment grade bonds are not. Balancing stability and risk in a portfolio though its stock and bond composition is a valid reason for holding bonds.

Good bonds, bad market

Just as there are good times and bad times for stocks, so it is with bonds. We are at the tail end of a 34-year bond bull market, where bonds and bond funds rose in price as interest rates fell. There isn't much upside left in bond prices, and many retirees have been dealing with the painful consequences of low interest rates for the past six years.

If we consider only high quality domestic bonds and bond funds, removing currency and default from the risk equation, then to which risks are bondholders exposed? The one that currently garners the most attention is interest rate risk. The longer the maturity of the bond, the greater the risk. For example, a 30-year US Treasury bond that currently yields 3.08 percent would lose 19 percent of its value if interest rates rose by only one percentage point.

A different but related risk is inflation, which erodes buying power over time. We are currently in a low growth/low inflation environment, but no one knows where we'll be several years from now. With 10-year Treasures currently yielding 2.35 percent, a return to the long-term average inflation rate of 3.22 percent would mean that these bonds would effectively be losing 0.87 percent (known as "real bond yield") each year.

Another risk is liquidity. In a bond market panic, when there are many sellers and few buyers, bond prices can get crushed. Even though you may be a "buy and hold" investor, if the bond mutual funds you own have a lot of redemptions, fund managers will be forced to sell holdings in a down market and realize actual losses that get passed on to you and other fund owners.

How to be bond savvy

If you require a predictable income stream, bonds may still meet your needs if you can tolerate the low rates. However, there may be better alternatives for generating income, depending upon your situation. Here are a few thoughts:

- If you need income and safety, keep bond maturity short and quality high. I prefer investment grade corporate bonds with a 3- to 5-year maturity. Current yield is only around 2 percent, but that's the trade-off for interest rate and default protection.
- Consider "laddering" your bond holdings to improve current yield while positioning yourself to take advantage of improving bond yields. There are a number of exchange traded funds (ETFs) that make this easy to do.
- Beware reaching for yield. There is a good reason that high yield bonds are referred to as "junk."
- Consider other income generating securities: master limited partnerships (MLPs), real estate investment trusts (REITs), preferred stocks, and convertible bonds. Though more volatile than bonds, in the right amounts and combinations they could be a better way to address your income needs.

Ignore the "100 minus your age" rule and other archaic simplifications of so-called correct bond allocation. Your investments should reflect your needs and your timing, as well as the underlying value of the investments, so assemble your portfolio accordingly.

George Gagliardi is a fee-only financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. *This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.*