

Bonds Can Leave Investors Shaken Not Stirred

Most people invest in bonds because they want a steady, secure stream of income while reducing the chance of money loss that they might otherwise experience in the ownership of stocks. By offering relatively greater safety of capital with predictable returns, it is easy to see why bonds and other fixed-income investments appeal to investors looking for a safe haven for their money.

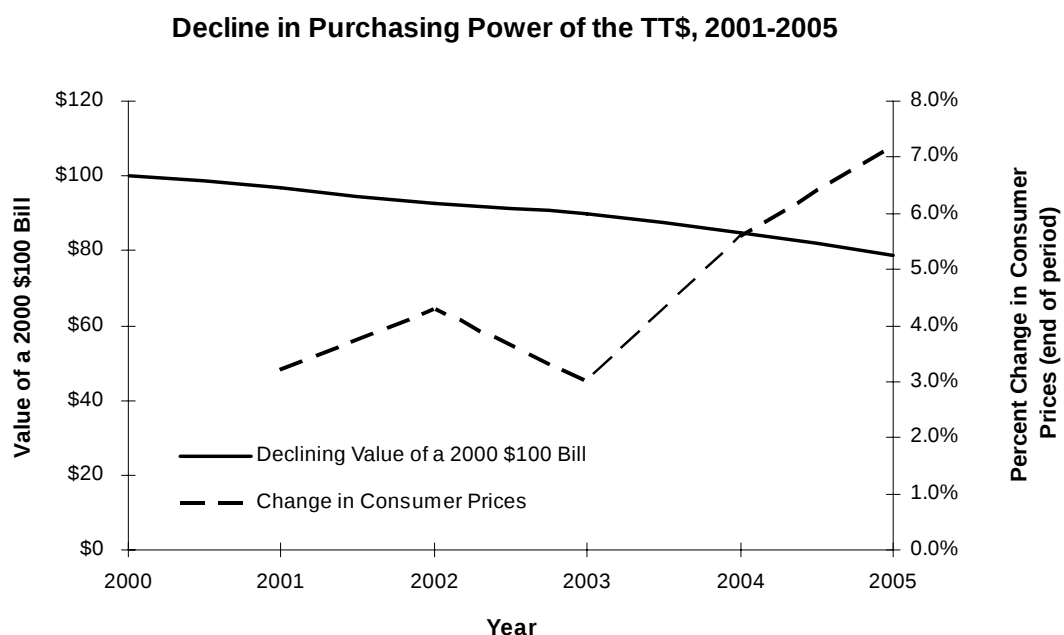
Although bonds may have a lower risk reputation compared to other investments, they are not risk free. While it is true that the risks are lower and the returns more predictable than in the case of investments in shares, investing in bonds is also subject to a variety of risks. In fact, it is just as plausible to regard bonds riskier than stocks depending on your definition of “risk”.

If you define risk in terms of volatility, that is, the magnitude of swings in annual returns, then yes – stocks are riskier than bonds. But volatility is a measure of short-term risk. When you lengthen the holding periods, the returns on equity become decreasingly volatile, so much so, that it is less risky to own stocks than bonds over the long-term.

Indeed, while there has never been a 30-year period where stocks produced negative returns, the same cannot be said for bonds or Treasury bills. Moreover, the long-term historical averages, which are likely to prevail, show the return on stocks comfortably beating fixed-income investments. Consequently, if you overload your portfolio with bonds, you pay the opportunity costs of missing out on potential investment returns.

When you purchase a bond, you are essentially lending money to an issuer who agrees to pay a specified rate of interest semi-annually, quarterly or monthly and to repay the principal to you when the bond matures. The interest payment is generally fixed over the life of the bond which is why bonds are commonly known as fixed-income investments.

Ironically, the guaranteed return that lures people towards fixed-income investing is also the biggest problem for bonds. The income is fixed. It does not increase as time goes on, while inflation continuously erodes the purchasing power of your principal.



Inflation has become a much bigger concern for investors in recent months. Their worries escalated after the Central Bank reported last month that its main inflation gauge, the Consumer Price Index, rose to 10 percent in October. The upward trend in consumer prices signals that we may have to live with higher inflation for some time – a risk that investors would be foolish to ignore.

Investors often equate risk with loss of principal. You buy a stock at \$45 and it drops to \$41. You've just lost (at least on paper) \$4 per share. The potential of principal loss with quality bonds is extremely low if held to maturity, but market risks due to inflation are very real. In an age of inflation, getting back your original principal is less than satisfactory if its buying power has seriously shrunk.

So while bonds may provide “safety” in its traditional sense through the preservation of principal, fixed-income investors are still taking huge risks by gambling that there will be no inflation to cause them a loss of purchasing power. Remember that the only value of money is what it buys. So unless your investments are outpacing inflation, you are losing.

If you accept the premise of continuing inflation, one of the simple bond strategies to minimise this threat is to shorten maturities. A shorter maturity will allow the principal to be reinvested at higher yields as interest rates rise. If the Central Bank resolves to fight inflation by raising interest rates, you wouldn't want to tie up your money in an 8-year Treasury bond paying 8% interest.

Not only would you be missing out on the potential income you could be generating from new, higher paying issues, the value of your bond in the secondary (or resale) market would also decline as the possibility of a better rate makes your bond less attractive.

The solution is to own bonds with different maturity dates through a strategy known as “laddering”. For example, if you have \$25,000 to invest you would ladder by putting \$5,000 in one, two, three, four and five-year bonds. When the first bond matures in a year, reinvest the money in a five-year bond, which will provide you with the highest available interest rate at the time. When the second bond matures in two years, invest in another five-year bond and so on, until all your money is invested in five-year securities.

Staggering maturity dates will not eliminate principal fluctuation or prevent you from earning below-market rates at times, but it will improve the flexibility and reduce the potential volatility of owning a portfolio full of bonds with the same maturity date.

In addition to fluctuation in value prior to maturity, another risk for bondholders may be the financial condition of the borrower. Conservative investors should only consider purchasing bank-quality bonds with a Moody's or Standard & Poor's rating of A or better.

Typically, the lower the credit rating, the higher the default risk and the more an investor demands in yield compensation. And while high rates of interest can be very attractive, the increased peace of mind is usually worth the reduced interest offered by quality bond issuers.

If you plan to invest in individual bonds, you should have enough money to achieve some degree of diversification by investing in a variety of bonds with different maturities. For the small investor, mutual funds provide an inexpensive, nearly effortless way to diversify your bonds.

Bond funds also offer investors monthly dividends which can be reinvested automatically as well as greater liquidity than individual bond issues. The biggest drawback to bond funds is that they don't have a fixed maturity, so that neither your principal nor your income is guaranteed.

Mutual funds that invest in both stock and bonds are known as “balanced”, “income & growth” or “asset allocation” funds. By allocating a portion of the investment to more volatile assets (equity), balanced funds provide a measure of portfolio growth and reduce the impact of inflationary pressures over time.

In the long run, stocks are extremely good hedges against inflation because the value of their claims on real estate, such as plants, land and intellectual property generally rises with prices. Unlike bonds, which pay fixed coupon rates, common stock dividends are not fixed and can also increase to provide the growth every portfolio needs to protect purchasing power.

That's why bonds are not enough for your portfolio. Bonds may provide safety of principal but don't be lulled into a false sense of security. If you become a fixed-income investor, you should be aware of the disadvantages of such investments and their potential to gradually erode your wealth.

Proper portfolio balance calls for both common stock to provide asset growth, and bonds to provide income and additional safety. Your Financial Advisor can help you determine the appropriate allocation of assets based on your personal financial goals, investment objectives and risk tolerance.