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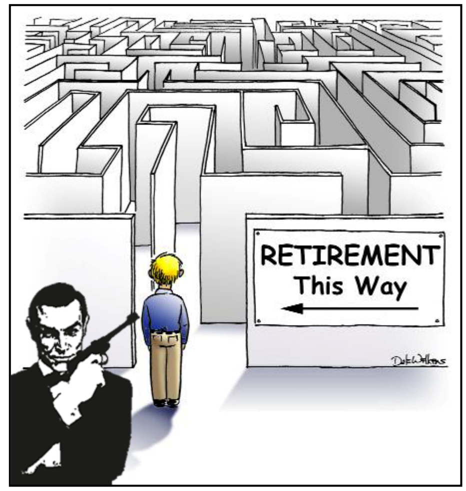
Steer Clear of High Risk Bonds

Navigating the Retirement Maze



"Bonds promoted as offering risk-free returns are now priced to offer return-free risk."

- Shelby Cullom Davis, NY investment banker (1909-1994)

Owners of bonds and bond funds got a chance to "feel the pain" back in May when Federal Reserve Chairman Ben Bernanke uttered the word "taper" – a reference to the Fed's eventual winding down of its monthly $85 billion bond purchasing program. Since then, the rate on the 10-year Treasury bond had climbed from 1.94 percent to 2.78 percent. While a less than one percent increase doesn't seem all that significant, it has had a major impact on bond prices. 30-year Treasuries have lost 10 percent of their value, equivalent to over three years' worth of dividend payments. So much for bonds being a safe investment.

This is not to say that bonds don't belong in your portfolio. They tend to be less volatile than equities, and can provide a consistent stream of income. But you shouldn't own bonds without understanding the different types and attributes, as well as the returns and risks inherent in each.

Don't Get Killed Reaching for Yield

There are three primary attributes of bonds – nationality, quality, and duration – each of which offers different ways to increase yields, but carry different risks as well. Going global can get you higher dividends than in the U.S., but with the related risks of political turmoil and currency devaluations, and thus greater price volatility. The best way to acquire non-U.S. bonds is through mutual funds or exchange traded funds (ETFs), where risk is spread among different countries.

Bond quality is denoted by the rating given to bond issuers by rating agencies (e.g., Moody's, Standard & Poor's). The higher the rating, the lower the estimated likelihood of default. U.S. Treasuries and bonds from financially solid companies are accorded AA or AAA S&P ratings. Because of their relative repayment safety, they yield less than do bonds of lower ratings. High yield, or "junk bonds", have repayment risks commensurate with their rating, but sport higher dividends as a result. However, high yield doesn't always imply high risk. Bonds with S&P ratings of B and higher have historically had default rates of less than 1 percent. Check bond funds to see what percentage of each grade they hold to better assess the risk.

Rate Risk: A Clear and Present Danger

The third attribute of bonds – duration – is the one that currently has investment professionals the most concerned. Investopedia.com defines duration as: "A measure of the sensitivity of the price… of a fixed-income investment to a change in interest rates." While complicated to calculate, most bond funds list their duration, measured in years. Longer duration bonds have higher yields than similar bonds of shorter durations, but also greater risk of loss if interest rates rise. In the current low-yield environment, this risk is substantial. A rule of thumb is that for each percentage increase in interest rates, the price of a bond or bond fund will decrease by the percentage of the duration. For example, a bond fund with an average 10-year duration will lose 20 percent of its value if 10-year Treasury rates increase by 2 percent. Thus, investors reaching for higher yields with bonds of longer durations expose themselves to significant losses as rates rise.

In a recent survey sponsored by the financial services firm Edward Jones, 63 percent of respondents didn't know how increasing interest rates would affect their investment portfolios. This isn't totally surprising. Since the U.S. Federal Funds interest rate peaked at 19 percent in 1981, rates have been on a decline, which has meant gains for bondholders. Losing money on bonds is a relatively recent phenomenon.

Dodging the Bond Bullets

So what's an income investor to do? Fortunately, there are some options for bonds that provide decent yield and relative safety in today's environment. Rather than holding short-term Treasuries with miniscule returns – 2-year T-notes were yielding 0.39 percent at the end of August – you could take some calculated risks. One alternative is short-term high-yield bond funds and ETFs, with durations of 2 to 3 years and yields ranging from 3 to 7 percent.

Another choice is floating rate bank loan funds, also called senior loan funds, which periodically adjust their rates according to prevailing interest rates. Think adjustable rate mortgages for businesses. They currently yield between 4 and 7 percent, which will rise with interest rate increases. While interest rate risk is mitigated, there are still credit rating risks which vary across the different funds. Do your homework before investing.

As interest rates increase, bonds will become more attractive to purchase. Just make sure that you're a beneficiary of rate increases, and not a victim.

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