



February 2010 Hot Topics

Bonds: What You Need to Know

Money is flowing into bond mutual funds at a dizzying pace this year. If the trend continues, bond funds will attract more than twice as much new money as they did in 2008 and a stunning 11 times more than investors are putting into stock funds this year.

Bond funds don't ordinarily have greater inflows than stock funds, but may occur during periods of stock price volatility. This development is not surprising, but it is interesting nonetheless. Here's why.

Interest rates are low and the Federal Reserve is likely to keep them low for the foreseeable future. As long as joblessness remains a problem, the Federal Reserve will be reluctant to raise interest rate targets and, in fact, has little reason to do so. Interest rates are one way to control the growth of an economy. When the economy is growing too fast and is at risk of high inflation, the Fed can slow it down with higher interest rates. An economy with high unemployment is unlikely to suffer from too-rapid growth and job creation would probably suffer from higher interest rates. Thus higher interest rates are not likely until the jobless rate begins to decline.

Bonds 101

But interest rates will inevitably go up. When interest rates rise, the value of existing bonds typically falls, this may adversely affect a bond fund's performance. The face value of a bond and the current interest rate is an inverse relationship. And the reason is simple.

A bond is a debt instrument, usually tradeable, that represents a debt owed by the issuer to the owner of the bond. Most commonly, bonds are promises to pay a fixed rate of interest for a number of years, and then to repay the principal on the maturity date. In the U.S. bonds typically pay interest every six months (semi-annually), though other payment frequencies are possible. When interest rates are low the issuer is taking out a loan at a low fixed interest rate. This is no different than a person securing a long term mortgage at the low interest rate.

Bond Valuation

The value of any asset is the present value of its cash flows. So what happens to a bond paying 4% when the interest rate climbs to 8%? It will be valued at a discount to the face value to compensate the buyer for the lower than current interest rate. The longer the term to maturity the less it will be worth.

For example, let assume a new bond today that has:

- 1) 20 years to maturity
- 2) face value of \$1,000
- 3) interest rate of 4% paid semiannually

This bond will pay to the holder 4% of its face value in interest each year. Since it pays semiannually, there will be 40 payments of \$20 each and the \$1,000 will be return at maturity (at the end of period 40). If current interest rates on a CD was 1.5%, then buying this bond for \$1,000 may look like a good deal.

Let's say over the next five years the economy improves, inflation kicks in and the interest rate paid on a CD is 8% and you are thinking about selling this bond. Unfortunately, this bond is only worth \$777.63 because it represents an investment at a lower than current rate. A buyer will pay less than face value to compensate for the lower rate. Note, however, that the bond will still pay \$40/year in interest and return the face value of \$1,000 at maturity. (On the other hand, if the economy in the above example remains depressed and the current yield remains at 1.5%, the value of the bond will rise to \$1,176.)

Investors who were smarting from their losses may have soured on stocks and decided the conservative return potential in the debt markets might be more appealing than the chance of suffering further losses in the equity markets. Realize, however that currently issuing bonds will be trading at a steep discount to their face value if interest rates rise.

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It's important to remember that you will receive the interest payment semiannually and the full face value at maturity regardless of current interest rates. The concern is the opportunity lost because you could invest your money somewhere else and earned a higher rate of return.

Bonds vs. Bond Funds

There is a big distinction between bonds and bond funds. An investor who buys individual bonds is typically interested in generating income and preserving principal. Investors who are careful to stagger the maturity dates in their bond portfolios may be able to further reduce the risk of having to reinvest a large percentage of their principal when rates are low. This was discussed in the October 2009 article titled "*Managing Volatility with a Ladder*".

Bond funds generally employ a less conservative strategy by trading bonds before they mature in order to pursue gains by taking advantage of fluctuating interest rates. Bond funds will typically turnover their holding from 50% to over 200% each year. This may allow them to offer greater return potential, but sometimes with higher risk. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with the underlying bonds in the funds.

Bonds, bond funds and bond ETFs can play an important role in an investment portfolio, but they shouldn't be thought of as a safe harbor to park money until the stock market settles down. Bond funds/ETFs are used in a portfolio to balance and compliment the equity investments. In addition, they should be a part of every investor's portfolio because bond funds/ETFs produce monthly income.

Take for example, the Vanguard Long-Term Bond Index Fund (VBLTX). This fund holds a range of securities that approximates the performance of the long term (15 to 30 year) bond market. It opened in June 1996 and sold for about \$9.58/share. It finished December 2009 selling for \$11.56/share. In the mean time, it paid around 0.053 cents per share every month in interest payments. A purchase \$10,000 of shares in June 1996 would be worth about \$12,066 today and would have paid around \$55/month, or about \$660/year for a total of around \$8,900 in interest payments. A nice addition to anyone's portfolio. Note: The NAV of a bond fund/ETF is the only consideration when evaluating the fund's performance. Dividends paid are not a consideration.

The decision to purchase a bond fund should be made based on your personal circumstances, such as your time horizon, risk tolerance, and personal goals. Bonds and bond funds come in a variety of forms which were discussed in the August 2009 newsletter in an article titled "*Navigating the Bond Market*".

Exchange-traded funds and mutual funds are sold only by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

This material was researched and written by David Snellen.
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