



Investment Insights

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Keeping Your Balance

With the recent negative returns and volatility of the stock market, many investors have turned to bonds for stability. The flow of money from stock mutual funds to bond mutual funds has reached a torrent the past few months, with over \$53 billion leaving stock funds in the month of July, and \$28 billion going into bond funds. Clearly, investors are shell-shocked by the devastating bear market in stocks that has eroded account values over the past two years. But are they making a mistake by putting too much money into bonds?

Most investors should have bonds as a part of their investment portfolio. A well-diversified portfolio can include anywhere from 20% to 70% bonds. In general, the older you are, the more you should have allocated towards bonds. This is true for two main reasons: stability of value, and regular income. However, as the stock market has suffered through the worst bear market in 30 years, many investors have gone overboard with their bond allocations, moving entirely out of stocks and 100% into bonds. In fact, the largest mutual fund in the United States is no longer the Fidelity Magellan Stock Fund, it is now the PIMCO Total Return Bond Fund!

What is the risk in owning bonds? Your main enemy as a bond investor is inflation, and the corresponding rising interest rates inflation brings with it. As interest rates rise, the market value of a bond declines, sometimes dramatically. Take for instance a ten-year Treasury note. If you invested \$10,000 in such a bond today at the current rate of around 3.7%, and rates rose to 6% over the next six months, your \$10,000 bond would have a market value of only \$8,601, a loss of nearly 14% of your initial investment! This equates to over three years worth of interest earnings on that bond! And keep in mind, rates were 5.50% on the ten-year Treasury only six months

ago, so the above example is not an impossible scenario .It is true that if you hold the bond for the remaining nine and a half years, you will receive your \$10,000 back, but what if you needed to sell in the interim period? The market value can change dramatically, and many investors do not take this into consideration when investing in bonds.

What about bond mutual funds? Are they safer? Generally, bond mutual funds can be safer because they have a diversified portfolio of tens or hundreds of bonds, rather than a single issue. They also may have bonds of varying maturities, further reducing risk. However, a mutual fund never “comes due”, so if you suffered the fate of the previous example, and had a decline in principal value in your bond fund, there is no point in the future where the bond fund would give you back whatever principal amount you originally invested.

Does this mean you should never own bonds? Of course not. But it is important to understand the risks involved in any investment you own or are considering making. Bonds have a role in almost every portfolio, but as part of a diversified investment strategy. Remember, everything is good in moderation!

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