



Investment Insights

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Investing in Bonds

One effect of the negative returns in the stock market over the past couple of years has been a renewed interest by investors in bonds. In fact, some investors have abandoned stocks altogether in favor of the perceived safety of bonds. While it is important to diversify and have the right mix of investments in any portfolio, and bonds may represent a portion of your portfolio, it is also important to understand the risks involved in any investment, including bonds. With interest rates at 40-year lows, it is vital to consider carefully how you approach investments in bonds to avoid unpleasant surprises in the future.

When you invest in bonds, either directly or through bond mutual funds, you take on two primary forms of risk: default risk and interest rate risk.

When you buy a bond, you are in essence making a loan to the issuer of that bond. Default risk is the risk that the issuer of a bond might not be able to repay the loan. In this uncertain economy, defaults have been occurring at historically high levels. When an issuer defaults, the owner of the bonds can suffer a substantial or complete loss of principal. Default risk can be lessened by investing in highly rated bonds issued by stable companies. The most secure bonds are generally considered to be US Treasury bonds, which are backed by the full faith and credit of the US Government. To minimize the risk of defaults in your portfolio, you should focus on government and high quality bonds and bond funds.

Interest rate risk is also a big risk to bond investors. With interest rates at 40-year lows, it is important to take into consideration what a rise in interest rates would mean to the value of your bonds or bond mutual fund. Today (November 15, 2002), the 10-year Treasury Note is yielding 4.04%. Six months ago the yield was 5.25%, and in January of 2000 the yield was 6.78%! Should you buy \$50,000 of a 10-year Note today, and in two years rates are back up to 6%, your \$50,000 Note would have a market value of \$42,400. If you hold the Note until maturity, you will get your \$50,000 back. But if you needed or wanted to sell the Note after owning it for two years, the \$7,600 in principal you lose would more than wipe out the \$4,000 in interest you would have received in the first two years of owning the bond. You would end up experiencing a negative return over that two-year period! If you decide to hold the Note, keep in mind you are locked in at the 4.06% interest rate the bond had when you bought it, so your income does not benefit from rising interest rates.

Given the possibility that an economic recovery might happen in the next year or two, and that historically has translated into higher inflation and higher interest rates, the risks in bonds are very real and must be considered when weighing bond investment opportunities. If you are comfortable with the coupon yield on a bond (the interest rate the bond pays), and are comfortable with earning that return over the duration of the bond, then you need not be as worried (i.e. if you are comfortable earning 4.04% each year for the next 10 years as in the case of a Treasury Note). But if you are thinking of investing in bonds “for a while”, “until stocks settle down”, or “until the economy recovers”, be very aware that your returns can be negative should interest rates rise from their current low levels.

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