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A word of warning to bond buyers

Investing Wisely

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A new client recently came to me, having bought a bond fund almost a year ago at a local branch of a large bank. His goal was to invest in the bond fund for a short period of time and earn more than he was earning in the bank's money fund. At the time, the fund was paying a little over 4 percent, but after almost a year in this fund the position lost almost 4 percent of value. The net result was that my client broke even. He would have been better off staying in the bank's money fund.

A lot of money that should be allocated to long-term investments to fund financial goals like retirement is now being placed in short-term investments due to the uncertainty and volatility of the markets. My client did not have a short-term need for the funds he invested, and given the opportunity, I would have advised him otherwise.

More money has been invested in bond funds over the past three years than was invested in bond funds during the previous eight years combined. Most of the investors in these funds don't understand the risk in their choices. With interest rates at historic low levels, there is little chance rates will go lower. When interest rates start to rise, the value of these bond investments may likely lose value and this loss in value is likely to be greater than the income generated.

Many individual investors panicked during the financial crisis that began in 2008 and liquidated their stock investments. Human nature may have prompted investors to sell stocks when the outlook for the economy was uncertain, and this tendency was amplified when the very survival of our banking system was in question.

However, once investors sold their stocks and mutual funds, they were faced with the question of what to do with the cash from these sales. Interest rates in bank accounts and money funds were and continue to be very low, so many investors moved that money into bond funds based on their higher yields and stronger long-term performance. But, their performance record is somewhat deceiving as much of the recent bond fund performance is the result of the capital appreciation achieved as interest rates dropped during the past decade rather than from the income generated by the bonds themselves.

Invested properly, bonds have historically been a safe place to invest. If an investor purchases a bond in anticipation of using it for a future expense when the bond matures — a child's college tuition, for instance — then the investment may work well. However, many investors buy bond funds that do not have fixed maturity dates, intending to tie up their money for a fixed period of time without understanding the consequence when and if interest rates rise. When rates rise, the bond fund may lose value and the funds he was counting on may not be available as planned.

Dividend-paying stocks

The Federal Reserve recently pledged to keep interest rate low through the middle of 2013. This pledge applies to short-term rates, and because of it all maturity rates moved lower. Long-term rates are influenced by market forces and are expected to move higher in time. If the economy enters recession or continues to grow at a slow pace, interest rates will probably stay low and the risk in bonds may not be realized. Eventually the economy may start to improve and rates may start to rise.

With five-year treasury bonds paying only 1.20 percent and 10-year treasury bonds paying only 2.40 percent as of the end of October, it would not take a lot for rates to rise closer to their long-term averages. Factors that have the possibility of driving rates higher include inflation, an improving economy, or further downgrades in the credit rating of the United States.

Investors who are looking for current income and plan to invest for the long term may be better served by looking at dividend-paying companies. Many large companies pay dividends at yields that are higher than the 10-year Treasury bond and many of these companies have a long-term history of raising those dividends most years.

I helped my client who invested in a bond fund to reallocate the funds into a diversified portfolio of large company stocks with a focus on high-dividend payers. The portfolio is diversified into various industries with stocks from around the globe, and the average dividend yield on the portfolio is greater than 4.2 percent — a rate which certainly gives my client a measure of comfort in his decision to invest in these volatile markets.

If interest rates rise, a portfolio of dividend stocks is expected to hold up better than long-term bonds. Staying in cash is the safest strategy to avoid short-term volatility, but there is a limit to how long investors can remain in cash earning no returns when there are alternatives. NHBR

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