

# The Role of Bonds

## Stability & Preservation

The financial news media have recently been filled with stories about bonds, inevitable rate hikes, and the impact of such increases. Many financial-industry analysts believe cheaply available government money and low interest rates have underpinned the current economic and stock-market recovery, and any reversal of those policies threatens the stock-market rally.

Consider a simple investing axiom, “When yields go up, bond prices fall.” Because we have had a long period of low rates as the Federal Reserve eased monetary policy, interest rates, including bond yields, will in time rise. When interest rates rise, the value of any bonds or bond funds you hold will fall.

So what is the purpose of bonds in a portfolio? And should you do anything different with your bonds if interest rates (and bond yields) will eventually rise, . . . and bond values fall?

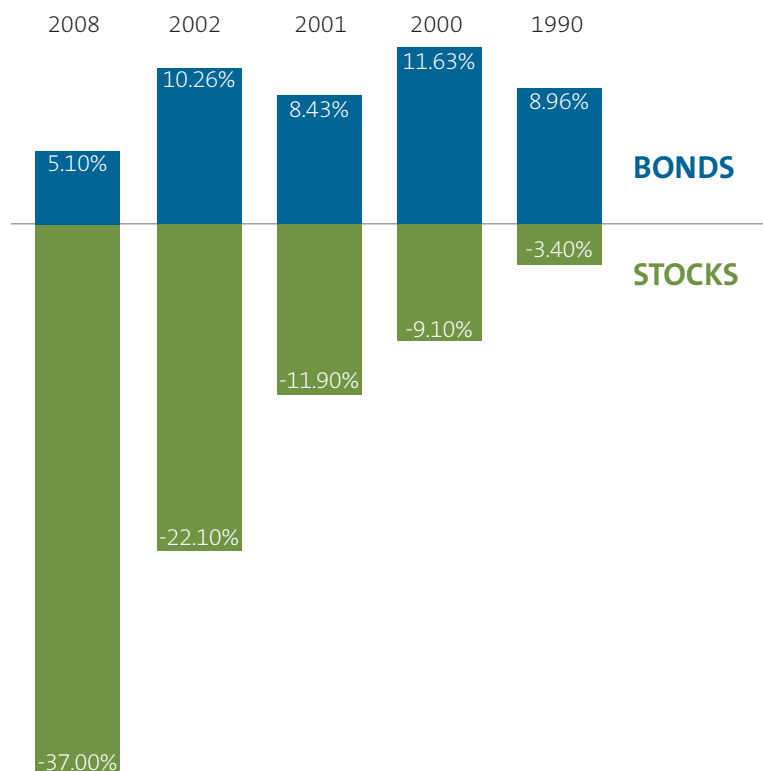
Think what bonds are: debt contracts sold by the U.S. government; government agencies; municipal entities such as local governments and water authorities; corporations; and many other types of institutions. When an investor buys a bond, he or she is lending money to the seller (the issuer), who agrees to repay the principal amount of the loan at a specified time and, typically, pay a fixed amount of interest periodically (why bonds are also known as *fixed income*

securities). That predictability—about the payoff date (or maturity) and the periodic payment of interest at a specified rate—underlies much of bonds’ value to investors.

### BOND RETURNS IN YEARS OF NEGATIVE STOCK RETURNS

SINCE 1981

■ Barclays Aggregate Bond Index; ■ S&P 500 Stock Index



### Bond virtues

Need a specific amount of money in three, five or ten years? A bond with a matching maturity can provide it and pay interest in the meantime. Okay, but couldn't one earn more in the stock market in that time? Maybe. But if the stock market—or your particular stock investment—nosedives just when you need the money, the consequences could be dire.

Need a steady flow of income, say in retirement? Consider bonds. High-quality bonds have virtues of reliability and stability compared to stocks, so they are great for preserving capital, too.

Bonds also have potential for appreciation and—here's the kicker—for balancing poor performance by other financial asset classes, such as stocks. Bonds are liquid assets that can be sold any time before maturity, and bond prices have no necessary correlation with stock prices. Best, bond markets have almost always provided positive returns when stock market returns were negative.



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Some types of bonds have additional virtues. Interest from municipal bonds is often exempt from federal and even state taxation. Interest from Treasury bonds is exempt from state and local taxes. And the principal amount of U.S. Treasury TIPS (Treasury Inflation-Protected Securities) increases with the Consumer Price Index—affording protection against inflation.

## Bond risks

Like stocks, bonds have varying degrees of risk. Bonds are rated according to risk by independent rating agencies, which assign each bond issue a credit-risk grade, from AAA (highly unlikely to default) to D (in default). As this suggests, bonds can lose value because of concerns about the issuer's ability to pay, with actual default on repayment the worst case.

Bonds can also lose value in the secondary market as a result of economic conditions. Both inflation and rising interest rates in the economy make the fixed rate of interest paid by a bond less

*bonds: usually positive returns  
when stock markets are negative*

attractive to a buyer. Bond prices move inversely from yield (interest payments expressed as a percentage of price). When buyers demand a higher yield to own a bond, its price declines correspondingly. Even U.S. Treasury bonds, which in effect have no credit risk, are subject to inflation risk and interest-rate risk, which increase with

the term of the bond. A 30-year bond has longer exposure to inflation and interest-rate increases (and therefore price declines) than a 3-year bond; so the “long” bond normally has a higher yield to compensate the buyer.

## Diversification, a basic principle

With bonds, as with stocks, diversification is the most fundamental strategy. Diversification can address both credit risk (Will your loan be repaid?) and interest-rate risk (Will a rise in interest rates mean a lower price for your bond when and if you sell it?).

Effective diversification can be accomplished by investing in shares of bond mutual funds that own numerous bonds of varying maturities. A mutual fund makes especially good sense for investments in high-yield (junk or speculative-grade) bonds, those with potential for the highest returns but with the highest credit risk. The margin of safety should compensate for the additional cost of indirect ownership through the mutual fund.

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