Money Matters

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Skloff Financial Group's Question of the Month: Bond Markets

By Aaron Skloff, AIF, CFA, MBA

Q: What I thought were my most conservative investments have been the worst performing for the first half of this year. What is happening in the bond market?

A: The Problem — Conservative on the Outside, Risky on the Inside
Many investors hid from the stock market collapse of 2007-2009 by parking their investments in bonds. They continue to hide there today. And why not? The Barclays U.S. Aggregate Bonds Index (BABI), a closely watched broad based bond index, returned over 19% from 2007 to 2009 and almost 20% from 2010 to 2012. The problem is a large part of the return was from capital appreciation, not interest payments – a good bet when interest rates are falling, but a very risk bet in the face of today's historically low interest rates. Since the principal of bonds move in the opposite direction of interest rates, a slight rise from historically low interest rates can be devastating to the principal of bonds. Even investments that are perceived to be conservative, like bonds, have risks.

The BABI lost over 2% in the fist half of the year. As interest rates increased from May to June the BABI lost over 3%. Another closely watched bond index, the Barclays US Long Treasury Index (BLTI), fared even worse. It lost almost 8% in the first half of the year.

The Solution — Understanding what's on the Inside
Bond returns are driven by two factors, the interest rate they earn and fluctuation of their principal. The interest rate is fairly straight forward. Generally, riskier borrowers must pay higher interest rates on their bonds to compensate for the higher risk of defaulting on the bond. A company perceived to be safe, like IBM, may only have to pay 3% interest on its bonds. A company perceived to be risky, like Morgan Stanley, may have to pay 5% interest on its bonds. Let's say you bought a bond from IBM that paid 3% interest per year and had a 10 year maturity. Each year IBM would pay 3% interest and return your principal at the end of year 10.

Credit Risk. With credit risk, from the time you buy the bond until the time it matures or you sell it, there is the risk the company defaults on the bond. The price of the bond moves inversely with the change in default risk. If there is an increasing risk that the bond will default the price of the bond will decrease.

Interest Rate Risk. With interest rate risk, from the time you buy the bond until the time it matures or you sell it, there is the risk that interest rates increase for similar bonds. Using the example of the IBM bond paying 3% interest, a 1% increase in interest rates for similar bonds to 4% makes the 3% bond unattractive.

[Remaining Article – Unpublished]

A Well Diversified Bond Portfolio. The same way you diversify a stock portfolio (not putting 100% of money in Apple), you should also diversify a bond portfolio. Diversifying a bond portfolio requires exposure to various levels of credit risk, borrowers with lower and higher risk of default. Generally, borrowers are less likely to default in an improving economy (like the one we are in now) and more likely to default in a deteriorating economy. It also requires exposure to various levels of interest rate risk, bonds with lower and higher modified durations. Generally, a higher modified duration is riskier in a low interest rate environment (as seen in the BLTI example above) since the risk of interest rates increasing is higher than them decreasing. A well diversified portfolio should also have domestic and international exposure. Restructure your bond portfolio if it does not reflect the level of risk you are comfortable accepting.

Action Steps
Work closely with your Registered Investment Adviser to evaluate the composition and risk of your bond portfolio. Falsely assuming it is the most conservative portion of your portfolio could turn into an expensive lesson.

Aaron Skloff, Accredited Investment Fiduciary (AIF), Chartered Financial Analyst (CFA), Master of Business Administration (MBA) is CEO of Skloff Financial Group, a Registered Investment Advisory firm based in Berkeley Heights. He can be contacted at www.skloff.com or 908-464-3060.