# Why Invest in Bonds?

The BIG THREE pillars of investing are Stocks, Bonds (sometimes called “fixed income”) and Cash. Other smaller investment categories include REITs (Real Estate Investment Trusts), commodities and alternative investments, etc.

In my experience, clients understand the pros and cons of stocks and cash but are fuzzy about bonds. Some of the reasons investors don’t understand bonds well include 1) the odd way they’re priced, 2) the fact that there are numerous types of bonds (short, long, inflation adjusted, municipal, corporate, etc) and 3) *their role in a portfolio.* Bonds appear to be “dull” to some investors but this short article explains why they belong in most investment portfolios.

Why Hold Bonds? Bonds don’t appreciate as much as stocks but they decline less than stocks when markets hit the skids. Long-term bond returns are lower than stock returns but they offer diversification by moving independently of stocks. Studies show that even a sprinkling of bonds in portfolios provides a “smoother ride” (less volatility) than holding stocks alone. Stocks need bonds to smooth the ride, and bonds need stocks because bonds can lag inflation and don’t grow as quickly as stocks.

How Much Bond Exposure Should You Have? There is no single answer to this question because every client is different. Some of my clients have as little as 10-20% bonds in their portfolio while others hold over 60%. Each client has a different portfolio depending upon income needs, risk tolerance, if the client is still working or retired, etc. A retired client, for example, may have a low risk tolerance and may have sufficient funds to last his/her lifetime without taking on too much risk. In that case, it’s possible this kind of client has 55% or more in bonds (plus some cash) and 45% or less in stocks/REITs. A young professional in her 30s may

have a higher risk tolerance, is beginning to save and may only have 15-25% in bonds.

Where Should Bonds Be Held? Bonds that are taxable at the federal and state level are best held in tax-deferred accounts like IRAs. Municipal bonds are best held in after-tax (non-tax-deferred) accounts. But if an investor is in a very low tax rate, it may make sense to hold regular bonds in an after-tax account if the yield is significantly higher than what he/she would enjoy with a municipal bond. Again, *it depends.*

How Are Bonds Priced? Mutual funds and Exchange Traded Funds that hold bonds and/or stocks are priced similarly (example: $11.55 per share or mutual fund). This way of investing in bonds gives investors liquidity but the bond maturity is “endless” since bonds continuously are added to a mutual fund or ETF to replace maturing bonds. The higher the bond risk (e.g. emerging market bonds), the higher the yield. You can confirm the yield of a bond mutual fund in e.g. Morningstar but the “yield” can change daily – just as a dividend yield changes daily even if the dividend remains the same, because the stock price changes.

By comparison, an individual bond may cost you e.g. $100 today and have a “yield” (the return the investor receives on this bond) of 3% per year today, but the same bond tomorrow may cost $102 and have a lower yield, or $98 and have a higher yield.

US interest rates have declined significantly this past year; a lower interest rate means a higher bond price. When commentators talk about a weak bond market, it means bond prices have fallen and yields are higher.

How Should You Invest in Bonds? Individual bonds require a commitment on the part of the investor because – ideally – you want to hold a bond to maturity to recover your promised principal. Along the way, you collect the fixed interest rate

payments promised to you and the initial cost of the bond is returned to you when it matures (a bit like a CD). The risk of a bond defaulting – and you losing your money – is low for most bonds but not impossible. Consider the unlucky investors who piled into Puerto Rican bonds that were offering rich (over 9%) yields when other bonds were offering much lower yields. The yields were high to entice investors because the quality was dubious. We now know why – Puerto Rico was suffering economically even before it was slammed by Hurricane Maria in 2017.

If you invest in a bond mutual fund or Exchange Traded Fund you aren't guaranteed return of principal and a stream of payments but you DO have liquidity and flexibility to buy/sell when you like.

How Do Bonds Look in the Coming 6-12 Months? There are doomsday predictions for both stocks and bonds in the coming 6-12 months but…there ALWAYS are doomsday predictions about stocks and/or bonds. The current consensus is that interest rates will continue to decline in the US and overseas as economic growth slows. This means many types of bonds remain attractive, even at current low interest rate levels. Yes, bond prices may be deemed "high" by some but they can go even higher (and yields can go even lower) – just as stocks can go higher still.

The best way to decide what bonds to hold should include an analysis of your risk tolerance, income needs, tax bracket and other financial planning considerations. Get input from a Fee-Only advisor who helps you see the "big picture" and has a Fiduciary responsibility to put your interests first.

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