INVESTMENT ARTICLE

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ENRICHING INVESTORS

Investing in Bonds Could Add Balance to Portfolios

By Robert E. Caplan, MBA, CFA

A few months ago we were asked to review the financial holdings of a recently retired 70-year-old man and give our opinion as to any changes we would make to his portfolio.

His account statements showed a well-diversified portfolio of mid to large-cap stocks, some holdings in small and international equity mutual funds, and a number of certificates of deposit at local banks.

When asked about any bond holdings, his response was, "I don't understand bonds, and I don't know how to buy them." He went on to explain his aversion to bond mutual funds "because they never mature and you may not ever get your money back."

When it comes to bonds, we have found that this kind of confusion and uncertainty is widespread even among seasoned investors.

The past several years have driven home the fact that a well-diversified portfolio with a good mix of stocks, bonds, cash reserves, and real estate can help weather turbulent times. All of these different asset classes do not move in lockstep with one another. Often, losses in one asset class can be offset by gains in another. Even a relatively small bond allocation of 15 percent to 20 percent can greatly minimize the overall volatility in your portfolio.

We have all read numerous investment articles lately that talked about the advantages of being "balanced." Now that so many folks finally see the light, they are faced with deciding whether now is the right time for bonds; what type of bonds they should add to their portfolios; and if they do buy bonds, how do they go about it?

Since the Federal Reserve has begun the process of raising interest rates, it may seem like the worst time to get into something that may lose value, should interest continue to rise. Money market funds, which invest in very short-term instruments, are currently paying next to nothing. As an investor purchases bonds with incrementally longer maturities, the yield they receive rises, but so too does the risk related to increasing rates.

In today's rate environment, yields rise quite rapidly as maturities extend out to the seven to ten year range, and then flatten out after that. This current steepness in the yield curve enables investors to vastly improve upon money market returns without taking on excessive risk. Most people know that long-maturity bonds are more volatile than shorter-term bonds. This volatility can be mitigated by "laddering" bonds across the steepest part of the yield curve.

Laddering entails buying bonds that mature in six months, one year, two years, etc., on up to where yields start to flatten. By laddering a portfolio of these shorter-term bonds, investors can more than double money market returns and still be fairly insulated from a gradual rise in interest rates. As the shortest bonds mature, the proceeds can be reinvested back out along the yield curve, taking advantage of potentially higher rates down the road.

If you decide that adding bonds to your portfolio makes sense, how do you figure out the right ones to buy?

The first decision is whether to buy taxable or tax-free bonds. As a general rule, retirement accounts and people in lower tax brackets net more income by buying taxable bonds, while higher-bracket individuals net a greater after-tax return by purchasing municipal bonds in their taxable accounts.

Individual bonds or bond mutual funds? Individual bonds have set maturity dates, which provides more certainty about the portfolio's expected cash flow. Even if you should buy a high-quality bond right before a big run-up in interest rates, you can expect that you eventually will get back the face amount of the bond. With a bond mutual fund many investors are combining their funds and delegating the responsibility of managing to a fund company. Cash inflows and outflows to and from the fund make the return of the original investment somewhat less predictable.

Numerous factors can affect the price of a particular bond, including the credit rating of the issuer, maturity date, coupon, call provisions, dealer mark-up, purchase size, etc. Different bond dealers can have widely divergent offering prices on exactly the same bond, depending on how badly they want to move it off their books.

Software applications from companies, such as Bloomberg, enable money managers to analyze specific bonds to determine a theoretical fair value and to use this information in negotiations with various bond dealers. By buying in large blocks — generally $250,000 or more — money managers also are able to negotiate more advantageous prices for clients.

To summarize, we feel that bonds can still play a positive role in a well-diversified portfolio. Investors should consider committing a portion of their investment pool to bonds to reduce portfolio volatility, not to mention the potential for higher returns.

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