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Bonds are not always a safe haven

Bond investments can limit volatility in a diversified portolio, but are not without their own special risks

SUMMING IT UP

William Rutherford

Bonds are generally regarded as a safe place to invest money, and generally they are. They can limit volatility in a diversified portfolio, usually provide some return and an investor usually gets their money back. But general wisdom frequently overlooks the fact that bonds come with their own special risks. Of course there is default risk, which occurs less often in quality bonds and more often in riskier bonds. Add to that the risk of inflation eroding the value of the bonds over time. Inflation can take a bite out of returns, especially if taxes apply. Then there is reinvestment risk, which is the risk that may occur when the bond is retired and the funds must be reinvested. Sometimes, reinvestment is at a lower rate of interest.

Bonds can be volatile. The volatility can vary with the length of maturity. Sometimes bonds demonstrate their volatility in a dramatic fashion, and even the experts can get it wrong. This past April was just such an example. As the year began, there was a flight to quality and a stampede out of equities into fixed-income securities as investors fled risk to safe havens. Bonds rose in value as investors bid them up. Since yields are inverse to prices, the yield on the bonds fell to very low levels. If you invested in bonds at this time, you received a low return in exchange for perceived safety.

Then came April. As markets calmed and investors perceived less risk, investors began to unwind their positions, returning to the equity markets and selling their bonds. Furthermore, expectations of Federal Reserve rate cuts began to mollify, and market-based interest rates rose.

Globally, bonds saw their biggest one day rout in five years and, for April, bonds had their worst month in years. The Lehman Brothers global index of government bonds saw a drop of 4.19 percent while the Lehman Treasury Bond index fell 1.83 percent. In the meantime, the S&P index was rallying to 4.9 percent.

This is not to say that bonds do not have a place in your portfolio. It is to say that bonds also come with risks, which an astute investor should appreciate – and we have just seen a glaring example of those risks. When reviewing your bond portfolio, keep in mind that there are different kinds of bonds. U.S. Treasuries are generally considered the least risky, although other sovereign bonds are also held in high regard. One needs to keep in mind, when investing in bonds denominated in currencies other than the dollar, that one assumes currency risk.

Corporate bonds are issued by individual issuers, so they come with their own special risk. Risk of default is usually rated by rating agencies, but lately the rating agencies acumen has been called into question.

Municipal bonds have been attracting attention of late because of an unusual phenomenon. Their yields have been higher than U.S. Treasuries, and are often tax exempt to boot. Such an occurrence is rare. There are a number of reasons for this occurrence: a flight to save haven treasuries, margin calls for hedge funds forcing the sale of municipals, and the rate of taxation in the U.S. is expected to rise no matter who wins the presidential race.

Also attracting attention recently are high-yield bonds, often referred to as junk bonds. These bonds generally have the lowest credit ratings and the highest risk of default. With the economy softening, these bonds are seen as even riskier.

Nevertheless, there is a market for them. Currently the market, quite efficiently, is compensating investors for additional risk by historically high yields over U.S. Treasuries. This could make these bonds attractive to an investor willing to assume more credit risk. Warren Buffet has been attracted to this market. Many investment companies offer high-yield funds and some even have offices in Oregon.

There are also convertible bonds, which combine the characteristics of bonds and equities. Bonds such as Ginnie Mae and Fannie Mae, while they do not have the backing of the government, it is assumed that the government would not let them default – an assumption that has never been tested. Bonds are also sometimes privately issued, but these bonds are not generally available.

Bonds can be acquired directly, or through closed and open-ended funds, and exchange-traded funds. As always, diversification is recommended.

CDs are an alternative to bonds, and many banks are offering attractive yields for long maturities. However, even CDs have unique risk.

The Federal Reserve, as expected, has cut the federal funds rate 25-basis points to 2 percent. In the absence of further shocks to the system, it is expected to hold there for some time. At 2 percent, the fed funds rate is less than the rate of inflation – which means negative interest rates, which is usually not a static state. (Although Alan Greenspan did it for some time with disastrous results).

The markets, including gold, commodities, and currencies accepted the Fed move and policy statement with equanimity.

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But I think the Fed move will be a positive for the dollar as Euro zone economies slow. It may also take some of the air out of some commodity prices if the dollar strengthens, as I believe it will. The European Central Bank, whose sole mandate is to control inflation, may be considering a rate increase in spite of the slowing economy in Europe. Ironically, I believe, they could do more to control inflation if they did not raise ECB rates – because the dollar would strengthen and commodity prices, particularly oil prices, should moderate.

Normalcy seems to be returning to financial markets. As it does, we may see investors moving money from bond safe havens to equities, thus lowering bond prices and bidding up interest rates.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.