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WHAT YOU SHOULD KNOW ABOUT BONDS AMID RISING INTEREST RATES

Bond investors had better brush up on their bond basics if they don't want to get burned by rising interest rates, caution financial planners.

In the last couple of years, as the stock market stumbled and interest rates declined, investors flocked to bonds. With good reason: in 2002, for example, long-term Treasury bonds returned nearly 17 percent and corporate bonds returned nearly 11 percent. And bonds performed well early in 2003, too. But bonds present risks, just as stocks do.

The first key to appreciating the risks is to understand that bond prices and yields move in opposite directions. When interest rates were falling in 2001 and 2002, the bonds or bond mutual funds you owned became more valuable. Say you owned a \$1,000 ten-year Treasury bond that paid six percent interest when you bought it. Since then, interest rates for new ten-year Treasuries have fallen to 4.5 percent. You can sell your Treasury bond for more than \$1,000 because it kicks off more interest than if an investor invested \$1,000 in a new ten-year Treasury. Thus, you earn capital gains if you sell the bond before it matures. The same principle applies to bond mutual funds.

Unfortunately, what goes down in the bond world eventually goes up. When interest rates rise, as they already are doing, the price of bonds or bond mutual funds falls. No one wants to pay full price for a bond that pays less in interest when they can invest the same amount for a bond that pays a higher yield.

Of course, even after rates rise, your older bonds may still pay a higher yield than newer bonds, but as interest rates climb you'll lose some—and perhaps eventually all—of the capital gains you made when rates were declining.

The second fundamental is that different bonds rise and fall in value at different rates. To understand this, start first with a bond's maturity—the length of time before the bond issuer is obligated to pay back the investor's principal (plus interest if the bond doesn't pay interest until maturity). In general, the price of longer-maturity bonds—a 10- or 30-year Treasury bond, for example—falls or rises faster in reaction to interest-rate changes than shorter-term bonds such as a six-month Treasury bill or two-year Treasury note (keep in mind that longer-term bonds usually pay a higher yield than shorter-term bonds).

This difference was evident in 1994, a rough year for bonds because of rising interest rates. According to the Investment Company Institute, the average long-term bond fund lost 6.2 percent in value that year, while the average intermediate fund lost 3.85 percent and short-term bond funds lost only 0.83 percent.

The technical description for this is duration. For example, a bond fund whose holdings have an average duration of two years will lose about two percent in value for each one percent rise in interest rates. A bond fund with a ten-year duration will lose roughly ten percent in value for each one percent rise in rates (funds gain correspondingly in value when rates fall by the same amount).

The third key is that none of the above matters if you own individual bonds that you hold to maturity. Bonds are loans to private companies or federal, state or local government entities with the promise—though not always the guarantee—that the issuer will pay back the principal, plus interest, by the maturity date. As long as you wait until maturity, you don't risk losing any principal due to a rise in interest rates, though you also can't gain any principal should rates drop. You earn strictly the interest, which is usually the reason you bought the bond in the first place.

This assumes, however, that the lender doesn't renege on its promise to pay back the principal, which is not always a good assumption to make with some corporations or sometimes even with government entities.

You can't eliminate interest-rate risk, however, if you invest in bond funds instead of individual bonds. That's because, with the exception of some funds such as closed-end funds, bond funds don't have a maturity date. They buy and sell bonds continually, which is why many experts recommend sticking to shorter-term bond funds in a rising-interest-rate environment.

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