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The risk to bond investors is real

In Side: The risk to bond investors is real

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Are you tired of it yet? How long have people been telling you interest rates were going to rise? Probably just long enough to get you to stop listening! Investors have made relatively strong returns in fixed income as our economic/political leaders lowered and drove rates to historically low levels. But, even at such low yields, investors have been willing to accept paltry returns because of their fear of the stock market.

Following a damaging period like the financial crisis, fears do not dissipate easily. Investors tend to follow trends aligned with current and lingering emotions, and that can be dangerous. You may recall that flows to stocks were at their maximum near the top of the Tech Bubble in 1999. Today flows into bond funds have been almost as ridiculous as investors have heavily allocated themselves largely away from stocks. Flows into stocks are suggesting ongoing pessimism but do investors realize what risks they might be trading for?

Investors scared out of the stock market

According to the Investment Company Institute (ICI) while flows to bond funds have grown by almost $1 trillion from 2007, stock funds flows have fallen. Total assets in stock mutual funds dropped nearly $700 billion dollars as of December 2012 (from the peak in 2007). For the year of 2012 Domestic Equity mutual fund outflows were over $122 billion. This was offset somewhat by net purchases of U.S. Equity Exchange

MARKET PERSPECTIVE

IN SIDE

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Traded Funds (ETFs) nearing $58 billion. Overall investors have shunned stocks but are they really safe in the alternatives they have selected?

The outflows from stocks are worrisome not only for investor's ability to grow their nest-eggs, but the alternatives they have chosen may cause even more heartaches later. While there has been much lip service discussing the risks to bond holdings in a rising interest rate environment one need to look back a few years to see what the risks may truly be.

It has been 30 years since there has been an extended bear market for bonds. There was a short bear market in bonds in 1994 when the FED increased the FEDS Funds rate 6 times and the average bond fund lost 4.6 percent. The last multiyear increase in rates that hurt investors was in the late 1970's and into the early 1980's. From 1977 through 1981 bonds suffered every year. Since the actual rates of interest paid on bonds were higher in that period, investors had a cushion against losses. Today that is not the case. With 20 year bonds yielding near 2 percent today, yields will not provide much protection.

Using research from Ibbotson Associates, we analyzed the "price only" (capital appreciation portion) of returns of government bonds so we could better provide apples to apples comparison to the past. In this period where Treasury Bills rose from a 5 percent rate in 1977 to over 14 percent in 1981, long term (20 years) bond prices fell over 10 percent per year through 1981. Granted, that return did not include interest, but as I alluded to before, today's yields do not provide much cushion. Bond investors need to understand the risks of holding long-term bonds in a rising interest rate environment, especially when a small change to rates today could mean a large percentage drop in prices from such a low yield level.

The risks are real, so what are the alternatives? While you hear numerous critics discuss the risks of the stock market in a rising rate environment we need to look at what actually happened in that period. While interest rates rose dramatically as T-bill rates went from around 5 percent in 1977 to over 14 percent in 1981. It may surprise you to see that stocks fared much better than bonds in the same period as large stocks provided a total return over 8 percent per year over the same comparable five year period.

The Bottom Line

Investing in the stock market carries risk and now so does the bond market. Rising earnings are generally good for stocks, but rising interest rates are bad for bonds.

Ibbotson	Gov't Bond Indices Returns	
	20 Year	Intermediate
1977	-7.86%	-4.49%
1978	-9.05%	-4.49%
1979	-9.84%	-5.07%
1980	-14.00%	-6.81%
1981	-10.33%	-4.55%
5Yr Annual	**-10.24%**	**-5.09%**

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