

Understanding the Risks of Bonds

The first wave of Baby Boomers turned 60 this year, which means that investing for retirement is taking on a new sense of urgency for these individuals. When making decisions about their asset allocation, preretirees and retirees typically find themselves paying more attention to bonds as an asset class, which may help to reduce a portfolio's volatility while providing a source of income.

While most investors generally invest in bond funds rather than purchase bonds outright, the potential risk associated with fixed-income securities varies considerably and is something that investors should be at least familiar with. Understanding these risks may help investors better craft an allocation or income strategy that is appropriate for their risk tolerance and time horizon.

Credit and Market Risk

In their simplest form, bonds represent a loan to an issuer such as a corporation, municipality or government agency. Bond issuers promise to pay the bondholder a specific amount of interest, usually quarterly or semiannually, and repay the full amount of principal on the maturity date.

Credit risk refers to the possibility that a bond issuer will default on a payment before a bond reaches maturity. To help investors make informed decisions, independent firms such as Moody's Investors Service and Standard & Poor's publish credit quality ratings for thousands of bonds. The upside of a poor rating is greater reward potential. Issuers of lower-rated bonds usually reward investors with higher yield potential for accepting the relatively greater risks. As a rule of thumb, bonds issued by corporations or municipalities with a triple-B rating or higher are called investment-grade bonds. Non-investment-grade bonds, with ratings as low as D, are sometimes referred to as junk or high-yield bonds because of the higher rates they must pay to attract investors.

If an investor is unable to hold a bond through maturity — when full principal becomes due — market risk comes into play. The investor will lose part of his or her principal at sale if a bond's price has fallen since acquisition. To help mitigate exposure to market risk, investors should evaluate their overall cash flow projections and fixed expenses between the time they plan to purchase a bond and its maturity date.

The Economy Also Plays a Role

Economic factors, such as interest rates and inflation, may also influence bond returns. Fixed-income prices tend to drop when interest rates rise, and vice versa. This inverse relationship is referred to as interest rate risk, which may be a particular concern to investors who do not plan to hold a bond to maturity. Exposure to interest rate risk increases with the length of a bond's maturity. Issuers generally pay higher yields on longer-term bonds than on those with shorter maturities.

Inflation risk is the danger that the income produced by a bond investment will fall short of the current rate of inflation. The comparatively low returns of many high-quality bonds such as U.S. government securities are particularly susceptible to inflation risk. In an attempt to remedy this situation and encourage more people to increase their savings, the Treasury Department in January 1997 began issuing inflation-indexed bonds, known as Treasury Inflation Protected Securities or TIPS, with a return linked to the inflation rate. These bonds index their principal to the Consumer Price Index, a gauge of inflation calculated by the U.S. Department of Labor.

Bond Funds May Be a Logical Choice

Not everyone has the time or knowledge to manage a portfolio of individual securities. With so many options to choose from, and

with individual bonds requiring initial investment ranging from \$1,000 to more than \$25,000, many investors opt for the ease of bond mutual funds. These funds offer the benefits of instant diversification, professional management and daily liquidity. However, because bond interest is taxable, these funds may trigger taxable events when they are maintained in a non-retirement account. Also, investors need to be aware that like individual bonds themselves, bond funds carry risks as well. Before investing in a bond fund, be sure to understand its risks and objectives.

The bond market provides a wealth of fixed-income products to suit virtually every investment goal and risk level. With all these choices, selecting investments that pursue your specific needs often isn't easy and the assistance of investment and tax professionals is advisable.

This article is not intended to provide specific investment or tax advice for any individual. Consult me, your financial advisor, or your tax advisor with questions.

