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Busting Myths About Bonds: A Key Ingredient of a Diversified Portfolio

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What you should know about bonds, why some misconceptions exist, and how bonds can set your portfolio up for the long-term—especially through volatile times.

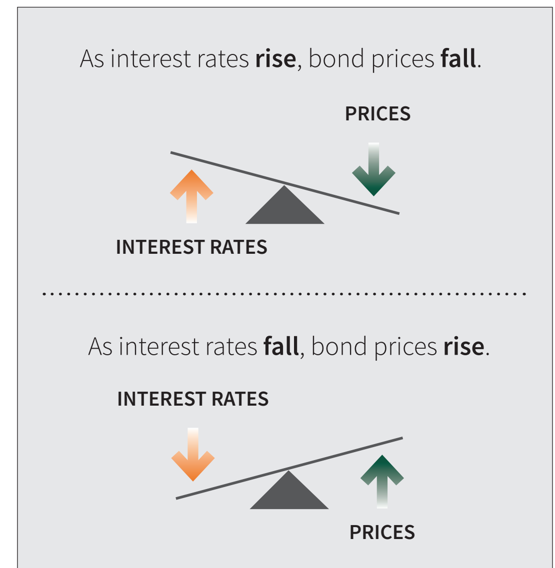
Many investors understand stocks: buy shares, and you get an ownership stake in a company. If the company does well, you likely make money, either through dividend payments or by selling your shares for a profit.

An investment in a bond, which is also a security, is different. Issued by governments, corporations, federal agencies, and municipalities in order to raise money, bonds are loans. Buy one, and you're lending money to the issuer, who agrees to pay you interest payments periodically *and* pay you back the principal when the bond matures.

In the bond market, performance and risk are tied to the creditworthiness of the issuer, the rise and fall of interest rates, and even broad investor sentiment. If these are not well understood, misconceptions about bonds can emerge. Here, we'll debunk a few myths and share some key concepts about bond market investing.

Misconception #1: Your return on a bond is equal to the interest rate it pays.

Total return for bonds is a combination of what you earn in interest income plus (or minus) changes in the value of the principal. One of the most important things to know about bonds is that *when interest rates rise, bond prices typically fall, and vice versa.*



Why does that happen? When issued, bonds pay an interest (or coupon) rate until maturity. Between issuance and maturity dates, bonds can be bought and sold through what is called the "secondary market." This is similar to the stock market, where after initial public offerings ("IPOs"), stocks are bought and sold in the secondary market. When you buy or sell a bond, you may have to pay a premium or sell at a discount (for less than face value [or par]). Let's say you bought a five-year bond with a coupon rate of 4%. If interest rates go up, newer bonds will have a higher coupon rate, perhaps 5%. To sell your bond in this example, you'd likely have to sell at a discount. That's the downside of what's known as interest rate risk. Conversely, if rates go down, your current bond holdings become more valuable, and you can elect to sell at a premium. If you hold the bond to maturity, you will receive your final interest payment plus the PAR value of the bond, from the issuer.

Misconception #2: I don't need bonds because I am not retired.

Bonds are generally considered an integral part of a diversified portfolio. No matter your retirement plans or status, bonds can help you preserve capital, generate income, and provide the benefit of diversification.

Bonds are typically less risky than stocks, so they can reduce the volatility of a portfolio and smooth out risk-adjusted returns over time. That's important, because when stocks decline, the stability of bonds can help investors avoid emotional decisions that can hurt long-term returns.

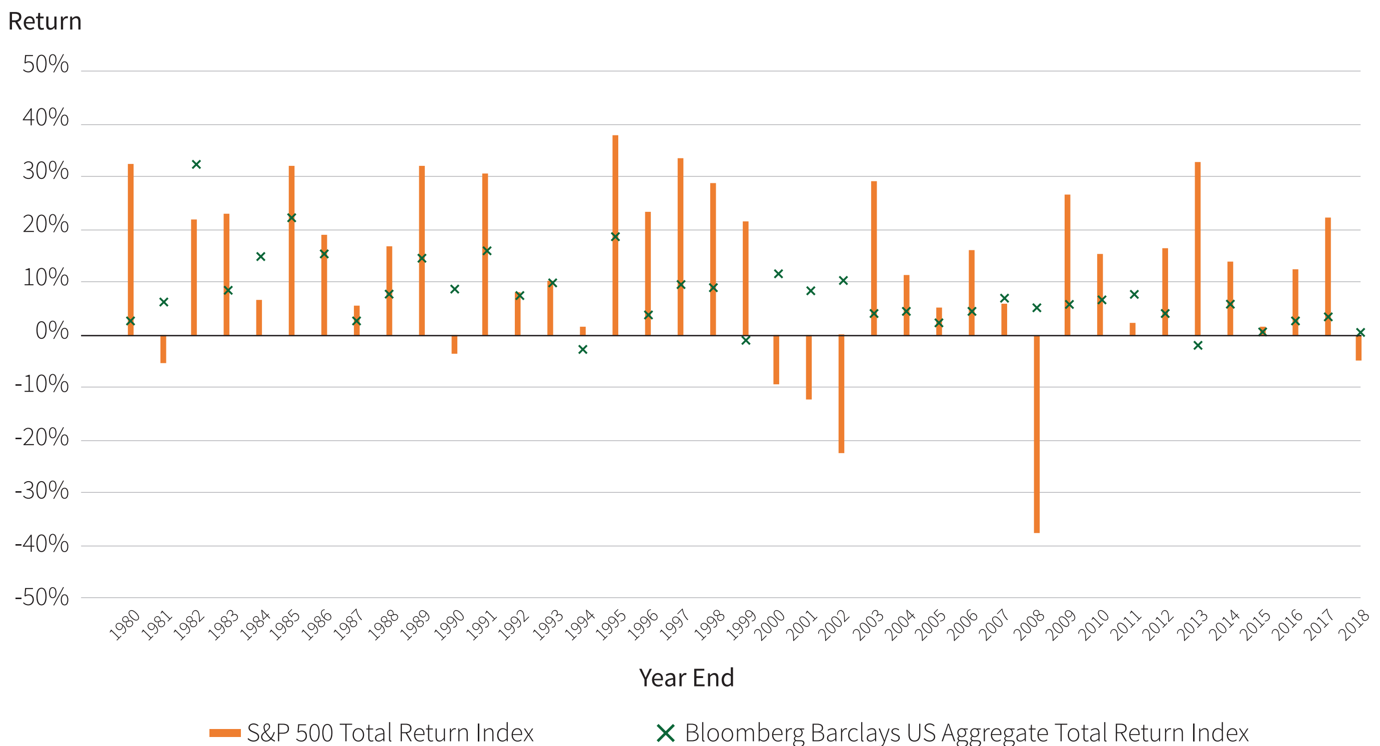
Bonds: Bigger than stocks

Did you know that the bond market is *larger* than the stock market? Globally, the value of the bond market has more than tripled in the last 15 years, driven in part by the low interest rate environment. It's estimated at $102.8 trillion,[1] compared to approximately $74.7 trillion[2] for the equity market. In the United States, the $42.8 trillion[1] bond market is significantly larger than the equity market, at $30.4 trillion.[2]*

*Source: The 2019 SIFMA Capital Markets Fact Book, an annual reference containing comprehensive data on the capital markets, investor participation, saving and investment, and securities industries.

[1]Debt outstanding.

[2]Market capitalization. For the United States, this is the combined value of NYSE and NASDAQ stock exchanges.



Misconception #3: Bonds are not risky.

You *can* lose money investing in bonds. There are a number of risks. These include, but are not limited to, interest rate risk as mentioned earlier, reinvestment risk, and credit/default risk.

Fortunately, there are ways to mitigate these risks. One key to limiting risk is paying close attention to credit quality and investing in higher-quality instruments. Independent rating agencies (including Standard and Poor's, Moody's, and Fitch) assess the risk of bonds by analyzing the issuer's finances and prospects, then assigning credit (or bond) ratings that help gauge a bond's risk level. It's similar to your own credit score: the better your rating, the lower the interest rate you'll get from credit card companies or loan providers. Buying only investment-grade bonds, which are on the higher end of the ratings scale, and avoiding non-investment grade bonds, also known as "high-yield" or "junk" bonds, can help reduce the risk of a bond portfolio.

Another important consideration in bond investing is **liquidity:** a measure of how quickly and easily one can buy or sell an investment at a reasonable price. All bonds are not created equal when it comes to liquidity. High-quality bonds, such as U.S. Treasuries, are very liquid, because people are almost always interested in buying or selling them. For the most part, the investment-grade corporate and municipal bond markets are also highly liquid. The lower a bond's credit quality, and the smaller the size of the original issuance, the greater the likelihood that it may be difficult to sell it when you want.

Common Bond Types Defined

U.S. Treasuries: Debt issued by the United States Department of the Treasury; guaranteed by the "full faith and credit" of the United States.

Municipal bonds: Debt issued by state and local governments.

Corporate bonds: Debt issued by corporations.

Misconception #4: Interest rates are predictable.

2019 proved again that this is not the case. After raising short-term interest rates in December 2018, the U.S. Federal Reserve rather suddenly reversed course and then lowered the key rate three times in 2019. This is a move which impacted the value of outstanding bonds. All the way back to 2009, many market observers have speculated that rates would rise, but it hasn't happened. Given the inverse relationship between interest rates and bond values, many investors, believing rising rates were inevitable, chose to "stay safe" in cash and short-term bonds and wait for rates to rise before buying back into longer-term bonds. Those who did missed out on some great returns.

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Bottom line, investing in bonds isn't always straightforward, and it can be valuable to work with someone with a deep understanding of bonds and the bond market.

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