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Bonds: Do they have a place in your portfolio?

During a recent visit to my daughter's birthplace in Roswell, a new client told me how nervous he still was concerning the stock market. He took me to his favorite restaurant and pointed to the chef, who was busy speaking into the pay phone in the rear room.

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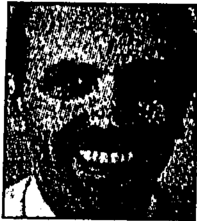

Real Money

"The guy is talking to his stockbroker right now, instead of making our lunch," my companion said. "You know, I believe we are headed for trouble when people stop focusing on their regular jobs because they think it is easier to make money in the stock market than to work for a living."

His comments were right on the money. I know of several people who have quit their jobs being lawyers, social workers, psychologists and carpenters to trade stocks. I don't believe that the recent downturn in the markets has dissuaded many of these people from the belief that they can earn a living based on riding the market's short-term swings. When stocks go down and stay down for a while, that will be the true test of our society's newest class of armchair entrepreneurs. Then, the subject of bonds will once more be relevant.

A bond, which is sometimes called a fixed-income investment, is simply the promise of a corporation or government to pay interest to an investor. The rates of returns on bonds vary greatly, from around 4.75 percent on very short-term federal obligations up to 30 percent for bonds of companies struggling to survive.

Bonds are essentially the debt portion of a company's status, much like credit cards and mortgages are the debt portions of most people's personal status. None of us like to pay 18 percent interest on the unpaid portion of our charge cards. Likewise, bonds that pay over 9 percent or 10 percent are usually associated with companies that have no other choice but to give out these kinds of high rates.

As in all investing, diversification is key. Many people who need income think that they should have only AAA or "insured" bonds. I believe that with the proper research and selection of fixed-income investments, one can enjoy higher returns that are only slightly below those available through long-term investing in the stock market. The trick to getting good returns on bonds is to find companies or municipalities that are small or not well known enough to attract large investors but whose fundamental financial situation is sound.

In New Mexico, we have many fiscally conservative public districts that need to raise money for schools, hospitals and other civic improvements. They do not want to spend the $50,000 it might cost to obtain an AAA or insured rating from an insurance company. We sometimes buy an entire bond issue ourselves, for our client accounts, and so the issuer, i.e., the public entity, can both give us a higher than market rate of interest and save money for themselves as well.

Besides producing income for the investors, bonds can also be used as an offset to the risk character of stocks. When the stock market goes down, money generally flows into bonds for their safety and bond prices go up. Correspondingly, in periods such as the great bull market of the last decade, most pundits shun bonds, forsaking

them as refuges suitable only for the timid and uneducated. Not so! Most long-term studies of portfolio performance show that the addition of bonds, up to 20 percent of an individual's overall portfolio, benefits his or her actual rate of return.

How can this be? Everyone has seen the charts of stocks trouncing bonds over the last 70 years. The fact is that most people, everyone I know in fact, do not have even a 20-year time horizon for their portfolio. When the market melts down, having some bonds does reduce the likelihood that people "freak out" and helps us as professionals convince a justifiably frightened investor to not liquidate all their securities when everything looks bleak and forlorn. We have not been faced with these circumstances in quite a while, but forewarned is forearmed.

Let's briefly talk about the different ways to buy bonds. The most widely known and convenient way is to buy a mutual fund. I believe this is akin to going into a mall, entering the first shop you come to and buying the first thing your hands touch on the rack closest to the door. It might work, the salespeople will love you, but in the end you will not know anything about what you have purchased nor is it likely that it will fit. If you see something advertised and you don't know anything about it, would you purchase it? Would you call an 800 number to order a product just because someone you know has talked about it? Most people would justifiably retort, "Of course not." Yet, this is the case for 90 percent of the people I see who own bond mutual funds.

You only have to learn one thing to understand the basics about bonds: bond prices go up when interest rates go down. Bond prices go down when interest rates go up. For example, a person owning a $10,000 bond at 8 percent maturing in 10 years would have a more valuable investment if the interest rates went down to 7 percent. Both the older, 8 percent coupon bond and 7 percent new bond would yield the same effective rate to a purchaser on the same date, so the person holding the 8 percent bond would be able to demand and get a higher price, approximately $106 for every $100 invested. This is a good example of how holders of the old 8 percent bonds have price appreciation on their bond.

Keep in mind that any price appreciation or depreciation goes away as you hold a bond to its maturity date.

Now, here is the difference between owning individual bonds vs. bond mutual funds. Owners of bond mutual funds never have a date of maturity when their principal amount is guaranteed to come back to them. In addition, as interest rates change, the fund holders' interest rates received will also change as the fund buys new bonds at the lower or higher rates. It is also difficult to know the exact ratings of each bond in the mutual-fund portfolio, whereas owning individual bonds lets one target specific credit quality. The concept behind owning individual bonds is to ladder their maturity so that you have some bonds maturing every year in order to rollover and protect the bond portfolio's purchasing power.

One can own bonds with maturities from anywhere from 30 days to 30 years. It is statistically shown that the highest interest rate differential is in the early years so we ladder bonds from six months to 15 years. Bond ratings go from Triple A (AAA), which are the U.S. government ratings, down to nonrated bonds. There are also bonds in reorganization or in default. We feel that there are advantages to owning a diverse portfolio of individual bonds with various ratings, which might include 20 percent of AAA bonds, 60 percent of A or BAA bonds, and 20 percent of BB corporate bonds.

The reason some smaller bonds are nonrated is because of the expense of obtaining a rating from insurance or bond-analysis companies. Especially in New Mexico, many small municipalities and low-income housing projects cannot afford to buy ratings. Investors who do their homework are well rewarded by buying these small jewels, which earn several percentage points higher than insured bonds. Remember — shop around before buying bonds as brokerage fees are easily hidden.

Think long and hard before buying any bond mutual funds because even though they are convenient and seem safe, they have inherent disadvantages. "Laddering" or buying individual bonds with staggered maturity dates is the way to go. Then, no matter what interest rates do in the future, your principal is protected. It is well worth the extra effort.

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