



Bonds – Easy Reader Version

If You Own Bonds, You Should Read This

We wrote a piece on bonds a few weeks ago in which the main point was that most bonds are losing money this year. We attempted to explain why. Having canvassed a few of you who read it, we now understand that it was difficult to understand. This is the easy reader version, which we are sending because it is very important to at least understand some concepts.

The basic point is this: generally when you buy a bond, you lock in the interest rate. If you hold your bond to maturity, you are guaranteed to get the rate of return that you bargained for at the time of purchase, as long as the issuer does not default. You can instead choose to sell your bond before maturity, but that price is not guaranteed. The price will fluctuate.

Let us repeat - the price, or market value of your bond, will fluctuate. Here's why. Suppose that you purchase a \$10,000 bond that pays 3% interest per year until its maturity in 10 years. In doing so, you have lent \$10,000 to the issuer (a company, government entity, etc) and it will pay you \$300 per year ($\$10,000 \times 3\%$) until it matures in 10 years. Upon maturity, the company will return to you the \$10,000 that you lent it. The "markets" determine what interest rates are paid, taking into consideration the length of time until maturity, the credit quality of the company, and supply and demand, to name the more significant factors. Note that "market" interest rates change all the time...we've all heard of mortgage rates moving up and down, for example.

Fast forward one year. Interest rates have risen and the same issuer (or one of similar quality) is issuing new bonds for \$10,000 that are paying 4%, or \$400 per year, and mature on the same date as yours. For whatever reason, you decide that you want to sell your 3% bond. What you would find is that buyers will not pay the same price for your \$10,000 bond paying 3% as they will for the new \$10,000 bond, paying 4%. In order to find a buyer, you will need to cut your price. Would an investor pay you \$9,990 for your 3% bond? No. How about \$9,500? Probably not. But drop your price low enough and you will find a buyer. That price is your new market value, and it is lower than your original purchase price. In case you are interested, the market price would likely be about \$9,250.

What is most important to understand is that generally, **when interest rates in the market increase, the value of a bond that you hold decreases.** On paper, you've "lost money" during the period. That being said, if you do decide to hold the bond, you will still receive the \$300 per year and \$10,000 at maturity, just as you expected when it was originally purchased.

Do not confuse interest rate changes with the Federal Reserve or the Federal Open Market Committee (FOMC), which set the very short term rates that mainly apply to inter-bank loans and deposits. The Federal Reserve only controls these very short term rates. The “market,” with all its participants constantly buying and selling, sets longer term rates. It is only a slight oversimplification to say that one has nothing to do with the other. Let me explain.

In June of 2004, the Fed (which is short for either the Federal Reserve or the FOMC) began raising short term rates. They raised short term rates by 4.25% over two years. So what happened to longer term rates during this period? The most closely watched longer term rate is the 10 year U.S. Treasury rate. That rate, as determined by the market, only increased by 0.43%. In fact, in the first year of rising Fed rates, the 10 year Treasury rate actually decreased. And by the way, stock prices increased during this two year period of rising Fed rates.

The two things that we are focused on are rising, longer term interest rates, because they will usually make your bond values decline, and earnings from stocks, because earnings are a fundamental driver of stock prices. We are less concerned with what the Fed is going to do.

For the record Gavekal, our economic forecasting firm, expects rates to rise by year end, to between 3% and 4% on the ten year U.S. Treasury, from 2.34% as of this writing (June 30). If they are correct, we will try to take advantage of the higher rates by recommending clients buy some longer term bonds, as appropriate.

What do we mean by longer term bonds? This depends on the specific client situation but in general, clients tend to resist buying longer term bonds. So let me put this in perspective. If you knew rates were going to stay the same or go down, you would want to buy the longest term bond you could find, generally, 30 year bonds. Why? Because longer term bonds generally get a higher rate, and don't you want a higher rate?

However, we don't know that rates are going to stay the same or go down, and we all fear that the value of our bonds will go down if rates rise. Many professional bond managers consider a 15 year term to be an average term – halfway between the shortest term (money market which is 0 years) and 30 years. All of our client portfolios have an average maturity that is shorter than 15 years. This would indicate concern over rising rates.

We are reviewing client bond accounts to see if average maturities are appropriate, especially if rates keep rising. It may pay to sell shorter bonds and buy longer bonds to increase the yield, even if that makes the average maturity longer and increases the risk associated with rising rates. Put another way, we need to determine if a bond portfolio is too short or too conservative.

We hope this helps you understand your bond investments. Even if it is not an easy read, we hope it also helps to clarify our thought process.

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