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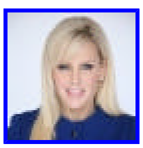

How Can We Discuss the Bond Bubble with Clients?

- Posted by Kimberly Foss on September 16, 2013 at 2:19pm
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Maybe it’s the appeal of the alliterative headline, but “bond bubble” has been getting plenty of play across personal finance pages. For investors who flocked to the relative safety of fixed income during the Great Recession, particularly women who tend to favor less market risk, the worry is real. After a long period of historically low yields, interest rates look to be on the rise. In fact, the Fed’s simple mention of plans to wind down its economy-buoying, bond-buying program resulted in a spike in interest rates that drove returns on bonds into uncharted negative territory. Now, the fear that rates will increase further and wreak more havoc for bonds looms on the horizon. What to do?

There’s no easy answer, but before discussing the options, I find that many of my female clients need a quick fixed income refresher course in order to appreciate the complex situation we find ourselves in. That’s not surprising because while it’s easy to gather information on stocks and equity mutual funds, learning about bonds is tougher. Without understanding bond basics, the headlines warning about a bubble provoke tremendous anxiety.

The role of bonds

The first step in my "Fixed Income 101" is to remind clients about the role bonds play in a portfolio. I present bonds as somewhat of a security blanket to temper the volatility inherent in stocks and other risky assets and a vehicle that helps create a reliable income stream. It's important to stress this fundamental role for younger women who, due to the threat of rate increases and all the recent headlines, may have the mistaken opinion that bonds are traditionally risky investments.

Interestingly, fixed income's product structure can also get in the way of female clients fully appreciating bonds. Sometimes I'll describe a bond as a mortgage in reverse. For example:

With a mortgage, the bank gives you a loan that you pay back in equal installments over 30 years with interest for the privilege of borrowing the money for your house. At the end of the mortgage's term, you own the house. In reverse fashion, when you invest in a bond, you give a government, company or municipality money, say $5,000. Then they pay you interest over the five, 10 or 15-year period of your loan for the privilege of using your $10,000. You get your $5,000 initial investment back at the end of the term.

The impact of interest rates

Another fixed income hurdle to clear is the inverse relationship between interest rates and bond yields. I often take pen to paper to explain that when interest rates rise, the fixed income portion of an investor's aggregate portfolio may face volatility and loss with the increase. There's a simple rule of thumb that many women appreciate -- pay attention to rising interest rates because a bond's value will decrease (by its duration) with each 1 percentage point rate increase. This helps women to get a quick sense of how their bonds might perform in a rising interest rate environment and is exceedingly helpful.

Market history

To allay fears of a complete bond meltdown, I've also been sharing some market history lessons.

In the history lesson, the conclusion is that while the fear of rising interest rates may be legitimate, a bear market in bonds is dramatically different from a bear market in stocks. A bear stock market is a 20 percent decline in prices, while a phase of negative returns for bonds can be defined as a bear market. 1994 was the worst year for the bond market, which plunged –2.9 due to increasing interest rates.

Most women investors feel comfortable maintaining their strategic allocation to fixed income after they understand the structure of bonds, the volatility and the math behind returns. Notably, because our bond math also reveals that during a parallel upward shift in interest rates, bonds with longer durations underperform shorter term alternatives, we are invested now in short-term bonds to reduce the impact of interest rate risk.

My goal with “Fixed Income 101” is to underscore for clients how bonds function as a diversifier to offset the riskier assets in their portfolio. With diversifying between stocks and bonds to stabilize portfolios at the core of smart portfolio construction, long-term investors can weather all types of markets -- even bond bubbles.

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