BUSINESS

PERSONAL FINANCE INSIGHTS

Bonds at risk?

LOUIS E. CONRAD II

Many investors view bonds as an investment with little risk — you receive coupon (interest) payments at regular intervals and once a bond matures, you receive the bond's face value. However, unless you hold individual bonds until their maturity, bonds share one risk: interest rate risk.

Bond prices move inversely to interest rate movements. For example, if interest rates rise, bond prices fall, with long-term bonds the most sensitive to interest rate movements. If your portfolio's bond exposure is held via mutual funds or you don't hold individual bonds until their maturity, your portfolio is subject to interest rate risk.

For the past 30 years since the highly inflationary early 1980s, the bond market has generally enjoyed a long-term decline in interest rates. The next 30 years are not expected to so kind to bonds. In the near term, an expanding U.S. economy will lead to higher interest rates. Over the long term, however, interest rates are likely to rise due to the increasing indebtedness of the U.S. government. Between the debt incurred from recent stimulus efforts, healthcare reform legislation, Social Security, Medicare, and Medicaid, the government will need to issue increasing levels of debt. To successfully issue this debt, the interest rate offered on U.S. Treasuries will need to rise to entice buyers.

Given the historically low level of interest rates today and the prospect for higher rates over the long term, many believe that U.S. Treasuries are the latest asset bubble to appear on the horizon. Other types of bonds, such as corporate and municipal bonds, will also face head winds as rates rise, but U.S. Treasuries may be hardest hit.

So what is a bond mutual fund investor to do in order to insulate his or her portfolio from the deleterious effect that rising interest rates have on bond prices? Here are some options:

■ **Short- or ultrashort-term bonds** — If your bond holdings are intermediate- or long-term in nature, consider shifting at least some of your holdings to short- or ultrashort-term bonds, which will do a better job of protecting your principal in a rising interest rate environment.

■ **Bank loan or floating rate debt** — One type of bond that performs well with improving economic conditions and rising interest rates are bank loan funds. Though below investment grade in credit quality, these funds hold adjustable rate debt that benefits when interest rates increase.

■ **High-yield bonds** — Commonly referred to as "junk" bonds and riskier than bank loans, high-yield bonds are less susceptible to rising interest rates because a greater proportion of their return is generated from interest income rather than the payment of the bond's face value at maturity.

If you hold individual bonds rather than bond mutual funds, consider a "laddered" portfolio of short- and intermediate-term bonds. Like the steps of a ladder, you hold bonds of varying maturity levels, which, in turn, provide diversification and reduce interest rate risk. Such a portfolio can reasonably weather the various economic environments that can confront a bond investor.

Remember that bonds, even U.S. Treasuries, are not immune to risk. To help preserve principal in a rising interest rate environment, consider making adjustments to your bond portfolio as outlined above.

Louis E. Conrad II is a Lexington resident and president of COMPASS Wealth Management, LLC in Lexington.