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The Bugaboo of Bonds

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While there aren't too many absolutes when it comes to financial markets, here is one that I do subscribe to – there is simply no risk-free place for money. So if you've always thought that "money is *safe* in government bonds," it's time to learn a little more about what that means.

The key benefits of bonds are stability and income and I believe that there is a place for them in a well-balanced portfolio. However, with interest rates at historically low levels, the next major decline could just as easily be in bonds as in stocks. Fixed income yields over the past year have reached depths not seen in over forty years, in part because of capital flying out of equities and into bonds. As buying demand has been placed on bonds, prices have been driven north (and yields have correspondingly been driven south).

> "The future is purchased by the present." – Samuel Johnson

Many people believe it is "obvious" that interest rates are going to rise and that bonds are going to generate poor returns. But investing is full of surprises and it is not uncommon for things to unfold very differently from what everyone expects. The real yield on 10-year TIPS (Treasury Inflation Protected Securities) is hovering around 2%. While not as low as it was a year ago, it implies growth in the U.S. economy (measured by gross domestic production) of just 2% for the next 10 years. All economic fundamentals point to sustainable real growth quite a bit higher. If that is the case, then bond yields are too low, perhaps much too low. And if the yields are too low, then bond prices are too high, perhaps much too high.

In the early 1990's, the Shearson long-term bond index dropped 15% in 13 months as the federal funds rate was increased seven times in one year. While the early nineties are not completely analogous to where we are now, it's an important reminder that both the stock markets and the bond markets have great capacity for surprise.

Bond valuations, as a whole, are not highly attractive today. Moreover, there are significant risks that were completely absent just a few years ago. However, bonds are not so overvalued that we should completely eliminate them from our portfolios. But the content of these fixed income allocations must be evaluated on a case-by-case basis and must be carefully monitored once implemented

A good financial advisor can help you evaluate your fixed income investments and recommend a strategy to incorporate bonds so that they work to balance your portfolio, not derail it.

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