

Potential Pitfalls of Bond Investing

Bonds present investors with a number of potential benefits. In general, bonds have provided investors with growth and less risk than stocks historically. Economic events that tend to decrease stock prices have sometimes increased bond prices, and vice versa. Because of this relationship, adding bonds to a portfolio might provide significant diversification benefits. Lastly, bond investors normally receive income at fixed intervals, helping to meet certain cash-flow needs.

However, as with any other investment, there are some risks that investors need to be aware of when adding bonds to an investment portfolio.

Interest-Rate Risk

Bonds and interest rates have an inverse relationship—bonds tend to rise in value when interest rates fall and fall in value when interest rates rise. Suppose an investor purchases a 20-year \$1,000 bond with a yield of 8% and interest payable annually at year-end. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for \$1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower coupon payments.

Inflation Risk

This is also known as purchasing-power risk. Inflation is a rise in the general level of prices for goods and services. If investments do not keep up with inflation, an investor's money will purchase less in the future than it did in the past. At their best, bonds have experienced very modest inflation-adjusted returns. Long-term government bonds returned 2.3% on an inflation-adjusted basis from 1926 to 2009, and long-term corporate bonds produced an inflation-adjusted return of 2.8%. Stocks, on the other hand, returned 6.6% inflation-adjusted.

Credit Risk

This is the risk of a company that is selling bonds not being able to make timely payments of principal and interest. The value of a bond might also decrease because of financial difficulties or the declining creditworthiness of the issuer. It is important to keep in mind that corporate bonds aren't guaranteed by the full faith and credit of the U.S. government but are solely dependent on the company's ability to repay the money that it has borrowed.

Liquidity Risk

Some investments might not be widely held by the public and can be difficult to sell (are not very liquid) if prices drop dramatically. Government bonds are usually very liquid investments; corporate bonds, however, might be difficult to sell quickly in certain situations.

Call/Reinvestment Risk

As interest rates fall, bonds with call provisions might be called (redeemed) by the issuer prior to maturity. While a premium is usually paid to the bond owner when the bond is called, this could leave the investor with the problem of reinvesting the principal at a lower interest rate.

Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks and corporate bonds are not guaranteed. Stocks have been more volatile than the other asset classes. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

Source: Stocks in this example are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Corporate bonds are represented by the Ibbotson Associates long-term corporate bond index, government bonds by the 20-year U.S. government bond, and inflation by the Consumer Price Index.