

BCA Market Perspective ©

Why Are Bonds A Risk?

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Since the sudden drop in bond prices in June, investors have been reminded of interest rate risk. While we are continually focused on default risk, it is Fed's zero interest rate policy in its fifth year that has investors worried. A shift by the Fed towards allowing interest rates to rise will push down the value of bonds.

There are two major types of risk in the bond market. One is the risk that the bond issuer will default on the bond. Selecting higher quality bonds with limited exposure to each issue and/or hiring a professional bond manager with a focus on quality will significantly reduce the risk of a default in your portfolio.

The second major risk is interest rate risk – specifically the price depreciation of a bond during a rising interest rate environment. As interest rates rise, the price (or market value) of a bond will decline. Let's consider a simple example: Assume you own a fixed coupon bond that pays 3% interest each year. If the market moves the yield of this bond to 6%, its price will have dropped by 50%.

As an individual investor, you may not be concerned that your bond has declined in value. You will continue to receive the 3% coupon every year and your money (or par value) back at maturity. However, pension funds, endowments and foundations are required to report the bonds at their current market value.

The threat of a rising interest rate environment from the current historical lows is the reason many investors view the asset class as "risky". Many believe there is a high probability that the market value decline of bonds will be more than the interest received if rates begin to rise, resulting in a negative total return for the bond portion of your portfolio.

BCA has discussed the risk associated with bonds with its clients for the past two years and has offered several solutions. Shortening the maturities (or the duration) of the portfolio is one way to lessen the impact of rising rates as bonds closer to maturity have less sensitivity to interest rate movements. Other alternatives to consider include floating rate bonds which reset the coupon based on a spread above a predetermined index. However, each strategy or asset class has its own individual risk characteristics and should be monitored closely to ensure they are meeting your specific objectives.

