

## Bonds still good bet if you can tolerate some risk

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Bonds are beginning to scare a lot of investors. Given historically low U.S. interest rates, government stimulus that is likely to spark inflation, and a massive flow of cash chasing returns, many people think that it is a bad time to invest in U.S. bonds.



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The interest rate concern seems to carry the most influence, particularly for investors who remember 1994 when they were surprised to see their bond investments lose value in many cases.

But it's not a certainty that the Fed will move interest rates off the floor – a negatively impacting bond prices – anytime soon. Many market professionals believe that the Federal Reserve will not be faced with a need to raise interest rates for at least another year, potentially well in to 2012. Unemployment will have to come down and inflation will have to be more obvious before there is pressure to raise rates. If the recovery continues to be a jobless one, we could continue in our low interest rate environment for a long time.

This means returns on cash will be miniscule, offering very little attraction as a bond alternative.

But the good news is, even if interest rates do rise, fearing their impact on bonds may not be necessary.

### BOND MARKET HISTORY

Past bond market performance gives us an indication of what returns we may expect when interest rates rise (causing the value of many types of bonds to fall).

In February 1994, U.S. interest rates began a relatively swift climb. They increased from 3.0 percent to 6.0 percent in one year. In that time, the Vanguard Total Bond Market Index Fund had a total return of negative 1.51 percent. Declines in the price of the fund outweighed income paid out by the fund for a full year.

Whenever interest rates do begin to climb, it seems unlikely that they will increase 3 percent in a year.

### A MORE LIKELY INCREASING RATES SCENARIO

It was just a few years ago that interest rates reached their most recent peak. In July 2004, the Federal Funds Rate was 1.0 percent. It reached 5.25 percent in September 2007. Bond mutual funds fared much better in this period of small increases over more than three years than they did during 1994. The Vanguard Total Bond Market Index had a total return of 14.19 percent. The long-term bond market gained almost 19 percent and short-term bonds 11 percent.

The index fund returns weren't exceptional but they still built wealth. International and corporate bonds performed even better, boosting anyone who held a well-diversified collection of bonds.

Even if you were to invest new money today in a broadly diversified mix of U.S. and foreign bonds, corporate and government bonds, the likelihood that you would experience even a small negative total return over more than a year is minimal.

If we turn the calendar back to 1973, we can see how the U.S. bond market performed during a wide variety of economic conditions, market expectations, and political changes. In the 38 years since then, the Barclays U.S. Aggregate Bond Index has had a negative return over a calendar year three times (-2.91 percent in 1974, -2.92 percent in 1994 and -0.82 percent in 1999). The 38-year average annual return (both price appreciation and income paid) was 8.1 percent.

I don't expect the U.S. bond market to average 8 percent returns over the next 10 or 30 years. But I do expect that bonds will continue to play a very important role in buffering the risk to an overall portfolio when the stock market turns negative, as it tends to do about one out of every four years on average.

### INCOME INVESTING FOR 2011

If a portion of your investment mix can't take even a minor loss in the next two years because the money is needed for essential expenses, the money should be in cash. That recommendation applies to any market environment.

If you can afford to take a conservative amount of risk, concerns about bond declines may be overstated from a longer-term perspective.

Especially if your fixed income investments include foreign bonds, corporate bonds and floating rate bank loans, which do well in rising rate environments, you could have a bond portfolio that reduces risk while still being positioned to provide positive total return.

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