Four Bond Market Risks That Can Impact Your Investment Portfolio

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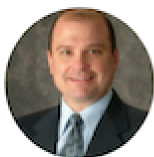

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I help people on their path to Financial Freedom. FULL BIO
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Typically, most investors are concerned about the rise and fall of the stock market. Daily stock market monitoring on the major business news outlets adds to a hyper short-term focus on the Dow Jones Industrial Average or the S&P 500. And yes, stock market moves will likely impact a portfolio more than movements in bonds, but the bond market will also fluctuate.

For near retirees, retirees, or people living off their interest and dividends, bond market adjustments, and movements in interest rates, matter. Investors with balanced risk profiles also invest in bonds within their diversified portfolios. These ‘balanced’ portfolios did well when the stock market rose, and interest rates fell (falling rates generally increased the value of their fixed income securities). Now, with the stock market hinting of a potential slowdown and rates starting to rise, investors are worried that both sides of their balanced portfolio are under pressure.

Bonds, also known as fixed income investments, are debt instruments issued by a corporation or government entity. Here are the four main risks of bond investing and how those risks can impact your portfolio:

Interest rate risk. When interest rates rise, existing bonds pay less than what a newly issued, nearly identical bond will pay. Therefore, in a rising rate environment, an existing bond is worth less than a new bond with similar features. This drop in the price of an existing bond from rising interest rates is called interest rate risk.

Not all bonds react to rising interest rates in the same way. Shorter-term bonds are less affected by a move in longer-term interest rates, and lower credit quality, higher yielding bonds are typically impacted less. However, high-yield securities may be subject to heightened market, interest rate, or credit risk and should not be purchased solely because of the stated yield. This underscores the complexity of bond investing, and why broad diversification and professional management may be prudent.

Credit risk. If the bond issuer is perceived to be struggling financially, then the value of the issuer's bonds will likely drop. The logic is straightforward: if an entity is less likely to pay you back, there is an increased risk element, and the bond's price will drop accordingly. This credit risk is also known as default risk.

This is a reason to complete your due diligence on each bond or work only with bond managers that have a proven track record of strong analysis.

Inflation risk. Inflation is when the prices of goods we pay for rise. When prices rise, it lowers the purchasing power of our dollars later. For bond investors getting paid a set amount of interest during a period when the cost of living rises, the value of the future cash flow they will receive is decreased. This loss of purchasing-power is known as inflation risk.

Treasury inflation-protected securities (TIPS), which are U.S. Treasury securities that are indexed to the Consumer Price Index (CPI), may see their value rise with inflation and could be a possible way to minimize the impact of inflation on your bond portfolio. However, during periods of low inflation, the returns on TIPS may be disappointing, so whether to include them is another complex decision.

Reinvestment risk. When you receive bond interest, you either spend it or reinvest it. The same can be said when a bond matures, and you (hopefully) earn your principal back. At that point, if you reinvest, you will be subject to the then-prevailing term structure of interest rates. If rates are lower, investors are subject to reinvestment risk which can be a significant concern for retirees and others who rely on bond interest to meet their monthly obligations.

This phenomenon became readily apparent after the housing crisis of 2008, when The Fed deliberately charted a low interest-rate course. This policy continues today with Treasury bill yields (and bank money-market yields) near zero percent, while the yield on the 10-year Treasury is less than the inflation rate. For example, investors who bought a 20-year Treasury Note in 2001, earned about 5.60%. Now they are lucky to earn just north of 2.00%. Investors wanting a similar rate to what they earned in 2006 must take on significantly more risk, which is not always recommended.

Overall, fixed income is generally considered to be a more conservative investment than stocks. However, risks such as those discussed above, indicate that due diligence, research, and plenty of diversification should be used when building a bond portfolio. With all this complexity, I suggest searching for a manager with deep resources who has consistently performed well in different types of rate and market cycles.

Contributor's Bio

Mark Avallone is the author of Countdown To Financial Freedom, and founder and President of Potomac Wealth Advisors, LLC a financial advisory firm serving clients through holistic financial planning and wealth management. Avallone writes on a variety of financial topics, and his contributions have appeared in the Wall Street Journal as well as in Forbes where he is a regular contributor. He has appeared on CNBC and has been a repeat guest on the Fox Business Network. His insights have also appeared in USA Today, U.S. News & World Report, The Washington Post, and other leading publications.

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