

Financially Speaking

With Trisha Arndt, CFP®

Bond Misconceptions Revealed

Several years ago a distant relative struck up a conversation with me at a family function about her investments. She explained that she had “learned from the losses” she had experienced in the tech bubble and had decided to invest all of her money in something where she was “guaranteed to get her money back”. She had visited her local bank and the investment representative there had helped her buy a bond.

I really dislike having investment conversations in social settings, but I felt compelled to point out that, while bonds are structured to return principal at maturity, the return of that principal is dependant on the bond issuer’s ability to repay it. While defaults are thankfully rare, they do happen so it is important to be comfortable with the issuer of any bond you buy. My relative made a polite response, all the while discounting every word I said since I obviously must not have the same expertise as the investment person at her bank.

The bond she had purchased was issued by General Motors. Oops.

When I saw her last year she made a point of not discussing anything remotely related to investing and I graciously didn’t bring it up.

With traditional bank accounts and certificates of deposit (CD’s) paying interest rates that are practically non-existent, a lot of people are looking at bonds as an alternative place for their money. In many cases bonds can make sense in this roll, however there are several significant differences between CD’s and bonds that must be understood.

First of all, a bond is a security. Generally speaking, between issue and maturity bonds trade on the open market – which means that their value fluctuates. When you own a CD the base value is fixed and you earn interest on top of it. If you decide to redeem it early you may have to give up some of your interest as a penalty, but the value you will get is set and understood in advance. If you decide you need to sell a bond before its’ maturity you don’t redeem it with the issuer – you must sell it to another investor for the highest offer. The price you receive can be more or less than the face value of the bond (i.e. the issue and maturity price, known as par).

So if the coupon payments (i.e. interest rate) and principal repayment of a bond are set at issue why would the price investors are willing to pay for it change? Generally speaking, there are three things that cause bond prices to fluctuate.

First of all, a change in the financial condition of the issuer could affect the price of a bond. If the issuer’s ability to make the interest payments and/or return the principal becomes less certain investors are not going to be willing to pay as much for the bond. They are going to want to be compensated more for taking the risk. For instance, if an

investor pays just \$800 for a bond that is scheduled to repay \$1000 at maturity, the investor is taking the extra risk in exchange for that potential \$200 reward.

I think the thing that is most confusing to people is how current interest rates can affect the price of bonds. In general if interest rates as a whole rise, the value of bonds will decline and vice versa. That may sound counterintuitive but it actually makes sense if you think it through.

Lets say you have a bond that was issued a couple of years ago with a 5% coupon rate (bond A) and a second bond that is about to be issued by the same company (bond B). Let's assume that interest rates are higher today so in order for the company to find buyers they have to issue bond B with a 6% coupon rate. If everything else about bond A and bond B are the same, why would investors pay \$1000 (the standard par price) for bond A when they could buy bond B at that price and get a higher interest rate? They wouldn't – and that is why bond values are lower when interest rates rise. The opposite is also true – bond values generally rise when interest rates decline.

Bonds are also affected by the economic environment as a whole, just as stocks are. Because bonds are securities and trade in markets that are an auction system, their prices are affected by supply and demand. The more bidders trying to buy a particular bond, the higher the price goes, and vice versa.

In general, when investors feel optimistic they have a greater appetite for risk (hoping of course to capitalize on greater potential return). During periods like that investors may shun many types of bonds and move more money toward assets they perceive to have a greater potential return, like stocks. Conversely, when investors are pessimistic (think September of this year) they will often pull money from stocks and move it to the perceived safety of bonds, pushing the prices up.

The bottom line is that bonds can be a very important and valuable financial holding but they are more complex than CD's and need to be fully understood. If you have additional questions please contact a qualified financial professional.

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