From Our Library:

What About Those Bonds?

You open your Fidelity statement or check out your balances online and notice your bond positions have gone down in value. How can this be? Aren't bonds supposed to be safe? Didn't my adviser say my bond funds are invested in "investment grade" bonds?

In the investment world, nothing can be described as completely safe. But those bonds going down in value may not be quite as risky as you think.

To understand what is happening with your bond funds, it's helpful to first understand how bonds work. Here is a basic introduction.

When a bond is issued, the issuer (a company or government) is borrowing money from the purchaser (you or a bond fund). A set amount is borrowed, $10,000 for example, for a particular amount of time, let's say 5 years. This is called the face amount. An interest rate is set, 2% for example, and the purchaser receives a payment every 6 months to compensate them for the use of their money. In this example, you receive $100 every 6 months.

Unlike many types of loans like a mortgage or a car loan, with a typical bond the issuer pays nothing back on the actual principal until the bond is due, in 5 years. At that time, the entire face amount is paid back to the purchaser.

For five years, then, you have received $200 per year ($1,000 total) and at the end of that time you get your $10,000 back. These terms are contractual. The bond issuer can't decide to change the interest rate or pay you less than the face amount on the "maturity date." The only way the issuer can avoid these terms is if it goes bankrupt or suffers some other undue financial hardship, and gets a court ruling that it can delay the payments or pay less. If a bond is rated "investment grade" that means it is considered unlikely that a financial hardship will affect the issuer in this manner.

That seems pretty safe, right? The problem comes if you, as the owner of the bond, decide you want to sell the bond before the maturity date. Now you have to find a buyer for it (your next-door neighbor for example). Your neighbor has no obligation to buy that bond from you. If he/she can find a better bond, paying a higher interest, he/she won't be inclined to buy your bond, right? What if you are really desperate to sell that bond? You could offer it for $9,500 for example. Now it might be more appealing.

What happens when interest rates in general start to move up? A new $10,000 bond might be offered paying 3%. No one wants to buy your 2% bond if it is very similar to a new one paying 3%. But if you hold your bond to maturity you will receive the face value for it, and you will continue to receive the interest payments that are contractually required until maturity. If you decide to sell it at $9,500 as in the example above, you will be out $500 plus the remaining interest payments.

In the bond market, bonds are being valued every day, based on the current interest rate environment. If interest rates are moving up, as they have been doing this year, most bonds will go down in value. If you own bond funds, this will be reflected in the value of those funds in your brokerage accounts. You will see it on your statement, or even on a daily basis if you go online and review your positions.

The good news is that as interest rates increase, those bond funds are buying new bonds as deposits are made into the fund and as existing bonds mature. Those higher rate bonds start to pay more interest, and the value of those newer, higher coupon bonds, hold their value better in the new interest rate environment. Two things happen in your brokerage account: (1) the interest associated with those bond funds starts to increase and (2) the value of the funds increases as well, if all other things are constant (no withdrawals or additions, no other market factors, etc.).

So, what should you do in a rising interest rate environment? Talk to your adviser about your particular situation, but don't be surprised if he or she answers with "stay the course." Now just may be a good time to buy bonds (or bond funds) that may be down in value. Buy low, sell high. That's how Phillips Financial's rebalancing system works. We sell portions of positions that have had great price appreciation and move the proceeds to positions or asset classes that have gone down in value.

As always, we encourage you to call your financial adviser whenever you have questions about your portfolio. He or she is in the best position to help you determine what adjustments, if any, will serve your best interests at the time.

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