Weighing the Risks of Bond Funds

Most portfolio allocations call for a mix of stocks (equities) and bonds (fixed income). The underlying theory is that stocks may deliver substantial results over the long term, whereas bonds contribute interest income and lower volatility.

As we've seen in recent years, stocks can be extremely risky but have recovered from periodic setbacks. Bonds offer low yields in today's environment. Therefore, one main reason for holding bonds is to dampen overall portfolio swings, holding down losses when stocks sag. This may help keep investors in the stock market and allow them to benefit in the next cyclical move to the upside.

Although bonds have not been as volatile as stocks, they do have risks. Understanding the possible perils may help you adjust your portfolio so that any fixed-income holdings are aligned with your risk tolerance.

Safety in Numbers

Today, many people invest in the bond market via funds. Individual bonds may be difficult for non-professionals to analyze, and the trading prices for small transactions in the fixed-income market might be relatively high.

When you invest through a fund, experienced portfolio managers make the buy and sell decisions. Often, these managers are supported by a research team. In addition, a bond fund may hold dozens or even hundreds of different issues, reducing investors' exposure to weakness in any one bond. Trading prices can be more favorable for bond funds than those for individual investors.

Investing in bond funds can reduce your fixed-income risk, but there still are possible pitfalls to consider.

Credit Risk

Buying a bond is essentially making a loan. Your greatest risk is that the borrower will fail to make scheduled interest payments or fail to return the loan amount at maturity. In times of overall economic weakness or specific issuer problems, perceived credit risk may increase. Then, the price of some or even most of the bonds held by a fund might drop, reducing the value of investors' shares. In the case of an actual default, the price decline can be severe.

Interest Rate Risk

Rising interest rates generally push down bond prices, even without significant credit risk. That's because higher interest rates mean that lower-yielding bonds are less attractive. Prices will drop to bring yields in line.

Example: Mark Tucker invests $10,000 in bonds issued by ABC Corp., which is in excellent financial condition. The bonds yield 3%, so Mark will collect $300 (3% of $10,000) in interest each year until the bond pays back his $10,000 at maturity.

What if interest rates rise to 4%? Investors can then receive $400 a year on a similar $10,000 investment. In this scenario, no one will pay Mark $10,000 for bonds yielding $300 a year. If he wants to sell his bonds, he might have to drop the price to $7,500.

A buyer acquiring bonds yielding $300 a year for $7,500 would be getting a 4% return, the going rate in this example. As you can see, a 33.3% increase in interest rates (3% to 4%) leads to a 25% drop ($10,000 to $7,500) in bond values. This is a simplified illustration, but it demonstrates the concept that rising yields will devalue existing bonds.

Reducing the Risks

The aforementioned risks can be mitigated by an adept selection of bond funds. To reduce credit risk, look for funds holding bonds from creditworthy issuers.

For instance, bonds issued by the U.S. Treasury have scant risk of default. Corporate bonds are rated by private agencies and those from financially sound companies are considered "investment grade." Standard & Poor's, one such agency, gives AAA, AA, A, or BBB ratings to companies considered to have low credit risk.

Bonds with lower ratings or no ratings at all are judged to have more credit risk. The term "junk bonds" may be applied to such issues, although they also may be known as "high yield" bonds because they must offer relatively robust payouts to attract investors. Online, you can see the ratings of the bonds held by various funds. A fund with average credit quality of AA, for example, would generally have little credit risk.

As for interest rate risk, that's largely determined by whether the bonds in the fund are long- or short-term. In the previous example, suppose Mark buys bonds that mature in one year. An interest rate rise might not drive down the bond price very much. In a year, Mark can redeem his 3% bonds and reinvest in 4% bonds, assuming interest rates hold steady.

Conversely, suppose Mark's bonds won't mature for 20 years. A buyer would receive his or her $300 annual payout for decades, locking in that scant return. That prospect could reduce the bonds' market value a great deal. For risk reduction, Mark should look for funds with relatively short maturity bonds.

Revealing Rates

The bottom line is that high-quality short maturity bonds typically have less risk than lower quality long-term bonds. Bond funds holding lower quality or longer-term bonds will have higher yields. Thus, looking at a bond fund's yield is a key indicator of the risks involved.

As of this writing, U.S. Treasury bonds maturing in the two- to five-year range yield around 2%. Therefore, any bond fund with yields significantly higher than 2% might be taking on meaningful credit risk, interest rate risk, or both. Lower-yielding funds may be relatively safe from share price deterioration.