knowledgeable thoughtful ethical experienced interactive

summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors August 2018

THE BENEFITS OF INVESTING IN BONDS

A client came to me once and asked for my input on investing in bonds. He subscribed to a third party investment newsletter, and in that newsletter, the author commented that bonds are not good investments because the yields are so low and therefore investors should always consider investing in stocks. I would disagree with this author. Regardless of your age, investing experience and portfolio size, there are good reasons to have some bonds in your portfolio. Typically, bonds can play three roles in your portfolio: capital preservation, income generation and diversification.

Capital Preservation

A bond is an investment that operates as a loan. When you purchase a bond, as an investor, you are lending money to a bond issuer who could be a wide range of organizations including corporations, municipalities, private institutions or governments. This bond issuer then uses your loan to fund new projects or support the day-to-day operations. In exchange for your loan, the issuer promises to pay you interest payments for a predetermined period. At the end of the period, which is the bond's maturity date, you will receive a return principal from the issuer, assuming no default.

Income Generation

The interest payments that bonds offer provide investors more clear and predictable income streams. One could argue that stocks pay dividends as well. However, stock dividends should not be confused with interest payments from bonds. Owning a bond means that you offered a loan to the bond issuer. The bond issuer has an obligation to pay you predetermined interest payments. However, investing in stocks represents your ownership piece of a company and receiving dividend payments is attributed to participating in the company's profit. Those dividend payments can fluctuate or stop at a company's discretion, which occurs more often during an economic downturn.

Diversification

One way to mitigate risk in your portfolio is to diversify your assets. Diversification as an investment strategy has layers of complexity. However, at its root, it is merely about spreading your portfolio across several asset classes and sectors, including U.S. and foreign stocks, bonds, and short-term investments. Diversification does not guarantee against loss; its primary purpose is to reduce the volatility in your portfolio. Typically, bonds do not move in the same direction as stocks. Therefore, they act as a cushion against equity market swings. Consider a side-by-side comparison. At the end of October 2007, Ms. Jane Doe has a $1 million portfolio, 100% invested in equities. If this portfolio was going through the Great Recession, which was from November 2007 through February 2009, Ms. Jane Doe would have seen the value of her portfolio reduced roughly by half. On the other hand, everything else being equal, if we invested 40% of the portfolio into bonds, Ms. Jane Doe would have suffered approximately a 25% reduction in her portfolio.

In today's market environment, bonds are essential building blocks for a well-diversified portfolio. If an investor is more concerned with the safety of their capital over the potential future growth of the assets, they should allocate more of their portfolio toward bonds. However, that safety has a price; bonds historically have not produced returns as high as stocks over the long term.

Everyone has different financial needs, investment time horizon and tolerance for market risk. One of the keys to successful investing is to figure out the balance between the need for capital appreciation and capital preservation. At Sigma, our goal is to help clients to develop a tailored investment plan based on their comfort level with risk. We consider not only the client's ability to tolerate risk but also the client's willingness to stomach market ups and downs. After all, no two snowflakes are alike.

Wenma Gorman, CFA, CFP®