SIGMA INVESTMENT COUNSELORS

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Not Without Risk

Early last year, I visited with my grandmother (Bubbie) and reviewed her portfolio. I was surprised to find that all of her investments were in common stock. My training and experience at Sigma have taught me that a retiree, barring unusual circumstances, should have a healthy portion of their assets in fixed income instruments, such as treasury or corporate bonds. I suggested to my grandmother that she consider selling some of her stocks and buying bonds. She asked me to explain how the bonds worked. I explained that, by purchasing a corporate bond, she would be loaning money to the company that issued the bond. In exchange she would receive interest payments twice per year, and a return of principal when the bond matured.

"Isn't that risky?" Bubbie asked. "No, it's quite safe, and much safer than investing in common stocks," I responded.

That was easy to say. It seemed obvious at the time. Aren't bonds a safe investment?

Like any investment, bonds do involve some risk. Fixed income analysts consider many types of risk when valuing bonds. In this article I would like to revisit the aforementioned conversation with my grandmother, and discuss why, at this time, bonds and bond mutual funds might prove more risky than in the recent past. After first describing the relationship between bonds and interest rates, I will discuss the interest rate risks and credit risks inherent in investing in bonds today.

As the bear market in stocks of the last 3 years has worn on, bonds have become increasingly popular. Bonds, and mutual funds that invest in bonds, seem like a safe haven from the volatility and losses characterized by most common stocks and equity mutual funds. In fact, in the last 2 years bonds have substantially outperformed stocks, earning returns beyond their semi-annual interest payments. Two primary forces have driven this performance. First, bond prices have risen due to greater demand. Again, this is at least partly due to the realization by many investors that stocks are a risky asset class. Second, bond values have risen as interest rates have fallen. This is an important relationship in understanding bonds. An illustration may be helpful:

A $1,000 bond is issued paying 5% interest per year. If market interest rates are 5%, then the bond is said to be at par, and worth $1,000. If market interest rates move higher, say to 6%, then potential buyers of the 5% bond now need an inducement to buy. They will only buy the 5% bond if they can get it at a "discount". Similarly, if market interest rates are lower than 5%, a bond paying 5% will be worth more and thus will command a "premium".

In other words, bond values move in the opposite direction of interest rates, and as the Federal Reserve has lowered interest rates over the past two years, bonds have increased in value.

Where does this leave investors today? Today, interest rates are at 40-year lows. Rates will probably remain low until the economy begins to strengthen. At that time the Federal Reserve will begin to nudge rates higher to "cool off" the economy and keep inflation under control. As interest rates rise, bonds will follow the relationship described in our example above, and decrease in value. For the bond investor who can hold a bond until maturity, this does not pose a problem. The par value of the bond is unchanged, and thus the full value of the principal will be repaid when the bond matures. However, bonds sold before maturity may be sold at a loss, or at a price below their peak value.

The problem of interest rate risk may be felt more acutely in fixed income mutual funds. These funds provide diversification to investors by holding a variety of bonds. As the value of these funds is recalculated every day, any change in interest rates is reflected immediately in the price of the fund. Because of historically low interest rates, many bond funds are trading at multi-year highs. This means that bond fund purchasers are paying a premium for the bonds held in the fund. If interest rates rise, that premium will decline, causing a drop in bond mutual fund prices that could take a long time to recoup. Thus, bonds and bond mutual funds are exposed today to interest rate risk, and purchasers should realize that the value of the underlying principle might be adversely affected.

Bond investors also face different forms of credit risk, including default risk and downgrade risk. Broadly speaking, credit risk refers to changes in a company's ability to pay the interest and principal of the bonds that it has issued. If a company's business is suffering, their bonds may be downgraded by the rating agencies, such as Standard & Poor's or Moody's.

Under the Standard & Poor's rating system, bonds rated AAA, AA, A and BBB are considered investment grade and not likely to experience credit problems, although AAA is much safer than BBB. Bonds with ratings below BBB are below investment grade, often called junk bonds, and are more likely to default than investment grade bonds.

Even if company default is not imminent, bond downgrades will cause the value of bonds to fall, as investors demand a higher interest rate to hold the company's bonds. If a company is in financial distress, investors may be concerned that the company will be forced into bankruptcy, which will provide protection from all creditors including bondholders. In this case, default risk is high, and investors will require a very high interest premium to hold the company's bonds. This can result in a steep decline in bond prices, with bonds selling for a fraction of their par value.

During the great economic expansion of the late 1980s and 1990s, companies were able to borrow funds to finance their operations. Many companies increased their use of debt, or leverage, to historically high levels. This increase in leverage enriched investors due to the relatively lower cost of debt and the related tax benefits. Unfortunately, the past three years have been characterized by much slower growth – or no growth at all - in most industries. In this environment, many companies are struggling to service their debt. At the same time, lenders are reluctant to extend additional credit. These conditions have led to many downgrades of corporate debt, and corresponding declines in the underlying bond values.

To summarize, investors must exercise caution when purchasing bonds, due to interest rate risk and credit risk. At Sigma Investment Counselors, we have formulated fixed income strategies to minimize interest rate risk. We build a portfolio of bonds with varying maturities, so as to minimize the fluctuations in price of the bond portfolio. Presently, we are concentrating on short and intermediate term durations. At the same time, we prefer to purchase investment grade bonds, from companies that we understand and follow. We do not take material credit risk to achieve better returns in what should be among a portfolio's safer assets. Through these related approaches, we offer what we believe will be solid fixed income returns while maintaining flexibility in a future rising interest rate environment.

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