If Interest Rates Rise, What Happens to Bonds?

Investors in longer-term treasuries could really be punished

Will bond investors soon suffer major losses? In the last few years, Bill Gross, Jim Rogers and other pundits have warned of a bond bubble. While it has yet to occur – the broad bond market yielded an annualized 4.42% from 2010-2014 – the threat remains.1,2

Quality bonds have a place in a portfolio, but many investors are directing their money elsewhere. Seemingly everyone believes the Federal Reserve will raise interest rates later this year, with bonds set to lose market value. Assuming the economy stays healthy and appetite for risk stays strong, what will happen to bonds and bond funds when rates begin to climb?

The impact of rising rates will vary. Bonds and bond funds are different animals; some might even call them different asset classes.

In a rising interest rate environment, bond fund investors will see principal values decline until rates level off or dip again. A diversified bond fund will reinvest interest payments into new bonds with higher coupons, however – meaning investors will see larger returns with time. 3,4

Long-term bonds tend to be hit harder by higher rates. They may lose market value, but eventually the higher rates will result in extra income for the patient investor.

How about short-term and intermediate-term bonds? Some analysts warn against purchasing short-duration Treasuries and municipal and corporate bonds, contending that these debt securities might be hurt the most should the pace of rate hikes quicken. Others disagree.

Higher rates have not always imperiled the bond market. Since 1975, our economy has witnessed six rising interest rate environments. They lasted from two to five years with T-bill rates increasing between 2.3-11.9%. In those six instances, the total annual return for Barclays U.S. Aggregate Bond Index (the S&P 500 of the bond market) ranged from 2.6-11.9%, with most of the total annual returns at between 4-6%. In short, no disaster for a bond investor. (Last year, the total return for the index was 5.97%.)2

Still, if the federal funds rate rises 3% over a period of a few years, a longer-term Treasury might lose as much as a third of its market value as a consequence – and if bulls run on Wall Street with only brief retreats between now and 2025, how attractive will a short-term or intermediate-term Treasury be?

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What if you want or need to stay in bonds? Some bond market analysts believe now might be a time to exploit short-term bonds with laddered maturity dates. The trade-off: accepting lower interest rates in exchange for a potentially smaller drop in the market value of these securities if rates rise. If you are after higher rates of return from short-duration bonds, you may have to look to bonds that are investment-grade but without AAA or AA ratings.

If you see interest rates rising sooner rather than later, exploiting short maturities could position you to get your principal back in the short term. That could give you cash which you could reinvest as interest rates go up. If you think bond owners are in for some pain in the coming years, you could limit yourself to small positions in government bonds, investment-grade corporate bonds and bond funds with durations of 10 years or less.

Bonds still belong in the big picture. In a bull market, putting money into an investment returning 1.5% for 10 years may seem nonsensical. It may make more sense in light of the goal of portfolio diversification and the need for consistent returns. If interest rates rise significantly in the next few years, current owners of long-term bonds might find themselves losing out in terms of their portfolio's potential. On the other hand, bonds have never lost half their value; stocks have.

Citations.

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2 – MARKETWATCH.COM/STORY/HOW-YOUR-BOND-PORTFOLIO-CAN-SURVIVE-HIGHER-RATES-2015-04-23 [4/23/15]
3 – MAINSTREET.COM/ARTICLE/HOW-TO-INVEST-IN-BONDS-WHEN-INTEREST-RATES-RISE-IN-THE-FUTURE [4/20/15]
4 – MONEY.CNN.COM/2015/04/29/RETIREMENT/BONDS-INVESTING/ [4/29/15]