THE MONEY MARATHON: THE PENDING BUBBLE IN BONDS
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With the dramatic drop in the stock market that occurred from October 2007 to March 2009 which resulted from the financial crisis, investors have understandably been bullish on bonds and apprehensive of stocks. In fact, since 2009 two thirds of a trillion dollars has poured into bonds which is more money than went into stocks during the internet bubble. Admittedly, bonds have had a 20-year bull market averaging an unprecedented 9% annualized return during that period. (It should be noted that investors who moved into bond funds in 2009 lost out on a 38% and a 15% return in stocks respectively in the last two years.) This euphoria for bonds may be creating a bubble that will disappoint investors in the future.

Let's look at some bond basics to examine why this bubble might bust.

WHAT IS A BOND? A bond is a liability of a borrower, normally a corporation or the U.S. Treasury. Bonds are called fixed income securities because normally the debt payments of the issuer are fixed. The issuer of the bond agrees to pay a fixed amount of interest periodically and to repay a fixed amount of principal at maturity.

WHAT ARE THE RISKS TO OWNING BONDS? Generally, there are five risks to fixed income securities. Those risks are interest rate risk, purchasing power risk, credit risk, liquidity risk, and call risk.

Here is a description of these risks:

* Call risk is the ability of an issuer to call or prepay the bond before its maturity which is bond specific and needs to be understood before purchase.

* Liquidity risk is the risk that a bond can't be resold prior to maturity at a reasonable price. Government bonds would not have this risk.

* Purchasing power risk is the concern that inflation will make the value of the fixed income payment less valuable with high inflation rates.

Normally, the two most important risks are these two:

* Credit risk which is the risk that the issuer will default and the owner will not get his money. A U.S. Treasury is considered to have zero credit risks, but any bond that is not issued by the government has some degree of this risk. Most bonds are rated for their potential risk by credit rating agencies. Bonds that are considered investment grade (banks can't buy a bank that is not investment grade), in order of quality from highest to lowest, are AAA, AA, A, or BAA. Lower rated bonds are rated below BAA starting with BA. These bonds are also called junk bonds or high yield bonds. The lower the rating or quality the higher the risk and therefore the yield. As an example, a 5 year treasury bond with no credit risk may yield 2%, but corporate bonds with some credit risk will yield more than this. A bond rated AAA may yield 3%, whereas a bond that is rated below investment grade might yield 6% or more depending on the risk.

* Market risk is the risk that the market value of the bond will change with a change in interest rates. This is the risk that many novice investors do not fully understand or appreciate. BOND PRICES MOVE INVERSELY TO YIELD. What does that mean? It means that when interest rates go down, the price of your bond goes up and when interest rates go up, the price of your bonds goes down. The longer the maturity of the bond or bond funds the more the price can change with a change in rates. A measure of this risk is a term called bond duration. A one-year bond might have bond duration of one, whereas a long term bond fund of 30 year bonds might have bond duration of 15. If interest rates move up 1%, the duration tells an investor approximately how much the price of the bond or fund will change, in this case 1% for the one year bond and 15% for a long term bond or fund.

WHAT IS THE RISK OF A BOND INVESTOR LOSING MONEY? To put a historical perspective on bonds and rates it is important to remember that bond yields and general interest rates have gradually declined since the early 80's when long bond rates were nearly 15% and the prime rate was over 20% until now when the long bond rate is approximately 4.4% and prime rate is 3.25%. Short term treasuries of one year yield about ¼ of 1%. The point is that rates have dropped so much that there is not much further that they can drop. The 1 year treasury could only drop ¼ of 1% down to zero but it could go up a lot and most likely will when the economy turns up. If an investor bought a long term bond fund for $100,000 today thinking that this was safe and long term interest rates went up 1%, from 4.4% to 5.4%, the investor's market value of the bond fund would drop approximately 15% to $85,000. If rates went up 3% to 7.4% for the long bond, that $100,000 bond fund would drop in value to $64,000 a 36% drop in value, hardly the safe investment that the investor might presume.

I think that within the next couple of years as rates start to rise, we are likely to begin a bear market in bonds which may continue for a number of years. What should an investor do? That will be the subject of next month's article.

Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.

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