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Bonds are safe, right?

By KEN EATON

It has been almost exactly five years since the collapse of the brokerage firm, Bear Stearns, the first shoe to drop in the start of the financial crisis officially brought on by its big brother, Lehman Brothers, five months later, and the start of the worst bear market for stocks in a generation.

Interestingly, no matter whether you were invested in stocks or bonds. During the last five years, you would have earned about 5.5% per year since then. Of course, the stock investor's ride was a virtual rollercoaster, while the bond investor's ride was more akin to the merry-go-round.

Now, the stock market is finally reaching new highs while interest rates are still near their historic lows, making you as an investor wonder where to put your money now. At first glance, if recent history is any indication of the future, then we should all be investing in bonds, given that they earned almost as much as stocks, but without all the ups and downs. But, we all know from experience that the future isn't always like the past, and investments that were perceived to be good and safe can turn sour.

A good investor always understands the risks, as well as the potential rewards, of any investment before purchasing it. At this point, the risks of investing in stocks are well-known to everyone, and most people know that even a bond can lose money if the company that issued it becomes less likely to repay what it borrowed. That's why many people choose to buy U.S. Treasury bonds when they are looking for a safe investment, because, if any entity can be expected to repay its debts, it is the U.S. government. But, how safe are they, really?

To answer that question, it helps to understand one fact about bonds. When interest rates go down, bond prices go up. When interest rates go up, bond prices go down. In fact, if all else remains equal, you can expect the price of the ten-year U.S. Treasury bond to change by anywhere from five to nine percent for every one percent change in the interest rate. The math related to this idea is a little complicated but if you are interested, you can find a good explanation here.

In 2007, before the financial crisis began, the interest rate on the ten-year Treasury bond was about five percent. To try to kick-start the economy, the Federal Reserve, the central bank of the U.S., embarked on a long-term campaign to push interest rates down, by, among other things buying Treasury bonds. Now, the interest rate on the same bond is less than 2.0%. So, anyone that bought bonds during that period, not only benefited from the interest that the bonds were paying, but also the increase in price.

Unfortunately, if interest rates increase, the bond investor can still keep the interest payments, but he will have to relinquish the appreciation and could actually lose some of his original investment if he is forced to sell before the bond matures. In other words, you can lose money in Treasury bonds when interest rates increase, and, with interest rates as low as they are today and an economy that is growing again, there is a strong possibility that they will have to increase in the future.

The point is not that you should sell all of your bonds today. No one knows when interest rates will increase, and something could always happen to derail the economy again. However, you should be aware that no investment is completely safe, and a balanced and diversified portfolio is still your best bet.

Just like Cheerios are an important part of a balanced breakfast, bonds are an important part of a balanced portfolio. However, just like eating only Cheerios can ultimately be detrimental to your health, owning only bonds can ultimately damage your chances for financial success.

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