Bonds - The Perfect Investment?

There has been a good deal of press in recent years about bonds outperformance relative to other assets classes. In an age of seemingly unending uncertainty and volatility in the financial markets, along with low interest rates on money market and certificate of deposits, many investors are turning to bonds with hopes of achieving their financial goals.

Governments, municipalities, and companies borrow money through issuing bonds. Effectively, an investor purchases a bond from the issuer with the idea that the issuer will pay back the investor periodic interest payments and the original principal amount at maturity.

The benefits of bonds are they can offer a reliable, consistent income payment to the owner of the bond. Some bonds even pay interest that is exempt from income taxation. Another benefit of bonds is they tend to outperform when stock values are down. The value of a bond is generally more stable than that of a stock. However, bonds have inherent risks that must be considered.

Bond investing carries risks, which include, but are not inclusive of, unique risks such as credit risk, interest rate risk, inflation risk, call risk and reinvestment risk. Credit risk refers to the issuers’ ability to repay the bond principal and interest. This risk is more transparent by looking at the bonds credit rating. Bond ratings give us some insight as to the institutions ability to pay the interest and principal in a timely manner. Interest rate risk refers to the risk that the value of the bond will change over time as underlying interest rates change. If you hold a 5% bond but underlying interest rates warrant similar new bonds to be issued at 6%, the value of your bond will decline. The opposite is true if underlying rates decline. Call risk refers to the fact that the issuer of the bond may be able to pay you back your principal prior to maturity. Reinvestment risk refers to the fact that once the bond is called or matures, you may not be able to reinvest those monies into a new investment with a similar rate that your former bond paid. While the risks of bonds need to be considered before investing, these risks can be mitigated by diversification of maturity (laddering), issuer, and geography. Bond offerings are subject to availability and change in price. If sold prior to maturity, municipal bonds may be subject to market and interest rate risk.

A properly diversified portfolio of cash, stocks and bonds can be important. Bonds can be an attractive addition to a diversified portfolio. However, before jumping into bonds because of their recently outperformance, carefully consider both the benefits and the risks bonds bring to your portfolio.

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