Why Buy Bonds If Interest Rates Will Rise?

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Article Highlights

- The concept of mark-to-market accounting is inappropriate for bonds held to maturity.
- A personalized ladder of individual bonds will finesse the possibility of rising interest rates.
- Investing in riskier assets to achieve higher returns can result in more downside risk than an investor can handle.

Many individual investors wish to buy bonds to achieve a secure cash flow and to reduce their risks in the stock market.

However, with interest rates at a low level, some investors are concerned that after they purchase bonds, interest rates will rise and their bonds will decline in value. We examine the validity of this concern, certain alternatives to bonds and our proposed solution to low interest rates.

You should not have to wait until the end of this article to get to our proposed solution to the low interest rate problem: We propose a bond ladder of individual bonds structured to take into account your financial needs and objectives. The bond ladder will finesse the possibility of rising interest rates. A bond ladder will also enhance your appreciation of the value of cash flow and power of compound interest.

The Problem of "Low" Interest Rates

We are told by the pundits and brokerage firms that rising interest rates are inevitable, like death and taxes. We believe that at some time in the future interest rates may rise, but no one really knows when this might happen. That does not stop the media from making dire predictions about the losses that will be inflicted on bondholders in the form of lower market values. To minimize these losses, the brokerage firms have been recommending investing in what we consider to be short-term bonds (around five years). If you followed this advice for the last five years, the result would have been a greatly reduced cash flow for many years and a loss of compounding the cash flow, as can be seen in Figure 1. And, interest rates have not yet gone up.

The truth is that no one really knows when or if interest rates will rise from current levels. The U.S. is currently beset with many problems. We are still recovering from the great recession, economic output is growing extremely slowly, real business investment is still slow and the reduction in the unemployment rate is inconsequential. Real median family income growth and middle-class jobs have declined. In view of these economic problems and the fact that the Federal Reserve is suppressing interest rates, it is unclear whether interest rates will spike up any time soon.

If everyone really believed that interest rates were going to rise substantially in the very near future, rates would go up immediately.

There are three possibilities with regard to the movement of interest rates:

- Interest rates in the future may go up,
- Interest rates may go down or
- Interest rates may stay within the current range.

Unfortunately, no one really knows what will happen. We personally come from a place of not knowing—we know we don't know the direction of interest rates, and we have not found anyone with a consistent track record of predicting the direction of interest rates.

Mark-to-Market Accounting

We believe that the mark-to-market accounting concept is clouding individual investors' understanding of the true nature of bond investing. The concept of mark-to-market means that every day, week, month or year (or multiple times a day), the current price of a bond is compared to the price at which you bought the bond. If interest rates go up, the market value of your bonds goes down and you are supposed to feel distressed about your bond investment. If interest rates go down, the market value of your bond goes up and you are supposed to feel happy and contemplate selling and taking your gain.

Although mark-to-market accounting is used by all brokerage firms, we believe that the concept is inappropriate for individual investors who are buying and holding individual bonds until their due date rather than trading their bonds. Why should gains and losses be presented when the bond coupons stay the same? Since the bond coupons remain unchanged, whether interest rates go up or down, the cash flow from the bonds stays the same. You receive the same income stream no matter what the price of your bonds is today or tomorrow.

Mark-to-market accounting is appropriate for bond funds since the funds never come due. The bonds in the fund must be sold when they no longer meet the fund's maturity specifications. Institutions must use mark-to-market accounting, but individual investors are not required to do so. If you use mark-to-market accounting, you will be terrified of rising interest rates. Brokerage firms like mark-to-market accounting because it encourages investors to buy and sell bonds, rather than hold individual bonds to maturity.

The media is hyperventilating over the possibility of long-term interest rates rising. For example, it was reported as news that the Barclays U.S. Aggregate Bond Index (the Agg), which tracks the broader bond market, declined 0.12% in the first quarter of 2013, the first negative quarter since 2006. However, most bonds are not reflected in the index, and most bond funds do not track it. In another example, The Wall Street Journal reported that "The guiding star for many bond investors is starting to flicker." Flicker, by definition means to shine with a wavering light, a light that soon may go out. However, any rise in interest rates has to date (April 5, 2013) been inconsequential.

Alternatives to Individual Bonds

Let's look at the alternatives to buying a portfolio of high-quality individual bonds.

One option is to stay in cash or cash equivalents (short-term Treasuries and insured bank products). Many investors would like to invest in these products to deal with the current uncertainties. However, everyone knows that interest rates are currently so low that the only way these products make sense for anything beyond very short-term (e.g., emergency) savings is if interest rates were to spike up quickly in the near future.

With interest rates low as a result of the repression of rates by Federal Reserve Chairman Ben Bernanke, investors have been encouraged to invest in riskier asset classes to try to improve their returns, even if they can't realistically afford the consequences of bad outcomes. Thus, investors have gone heavily into stocks, commodities, collectibles, junk bonds and other risky investments. Many of these investments are inappropriate for investors who have limited resources and who are nearing retirement or are in retirement because the downside risks are too great. Even dividend-paying stocks come with an uncertain outcome since, unlike bonds, they never mature and are subject to the stock market's volatility.

Floating rate notes have recently gained in popularity because it appears that they might enable you to hedge your bets. For example, one bank offered a step-up certificate of deposit (CD) in April 2013 that matures in 2018. For the first three years the interest rate is fixed at 0.85%, the rate you could get currently on a one-year CD. In year four, the interest rate rises to 1.25%, which is the current rate on a four-year CD. In year five it rises to a 2.00% yield, which is currently an above-average return. The problem with this investment is that you are locked in for five years. However, the issuer is locked in for only three years because the CDs are callable every quarter after April 2016. Keep in mind that for the first three years, you are being paid only 0.85%.

So, if rates are too low on traditionally safe investments, the risks are too great on commodities and junk bonds, and stock prices are subject to the market's volatility, what strategy should investors follow?

Figure 1. Comparison of Municipal Bond Investments

$100,000 invested for five years in tax-free municipal bonds with interest payments reinvested at similar yields.

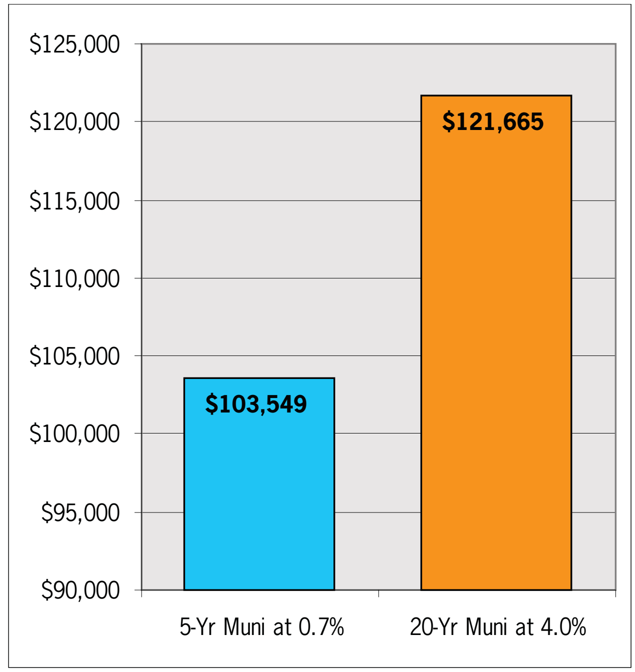
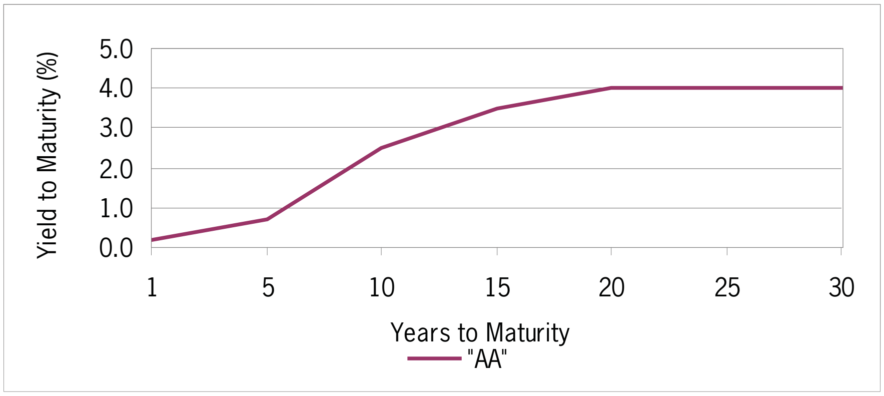


Figure 2. Municipal Bond Yield Curve



Data as of April 9, 2013.

The Benefits of a Bond Ladder

Individual investors are not institutions. We don't live forever. We should focus on our finite lifetime needs and goals, taking into account the risks of investments.

We recommend that you consider the benefits of a custom bond ladder. Briefly, a bond ladder of individual bonds is a strategy to have one or more bonds come due in multiple years. Thus, if you have $100,000 to invest, you might have a $10,000 bond come due in each of 10 different years beginning in 2014 and ending in 2033. This is the simplest form of a bond ladder. Alternatively, you might start your bond ladder in 2023 or later years and end in 2036 and have unequal amounts of bonds in each year.

In the strategy of the bond ladder, we find the solution to the problem of losses being generated from rising interest rates when using mark-to-market accounting. Whether interest rates are rising or falling, your bond ladder of high-quality bonds will produce a consistent cash flow that you can rely on.

If your bond ladder is in place before interest rates go up, you have the upside case when rates rise. This is because as interest rates go up, you will be able to increase your cash flow by reinvesting your bond proceeds (from bonds coming due and bonds being called) and your excess interest income in higher-yielding bonds. For example, if you are getting a 4% return and interest rates rise enough over time to give you a 6% return, your cash flow over time will increase by 50%. Thus, if your bond ladder is in place, rising interest rates will not be a concern but will be your upside case.

Guidelines for Laddering

Consider the following guidelines in the design of your buy-and-hold bond ladder.

First, consider whether there are certain years in which you know you will need cash. For example, if your child or grandchild will begin college in six years, you may want to have one or more bonds come due in years six, seven, eight and nine. If you plan to buy a residence in five years, buy bonds that will come due at that time. Always keep enough of a cash cushion so that you can be a buy-and-hold investor.

Second, once you have taken care of your known needs for cash, consider the shape of the yield curve. The yield curve is a chart that plots the interest rates being paid by bonds of the same credit quality but different maturities. In the chart, the interest rate is found on the vertical axis and the maturity on the horizontal axis. A current yield curve for AA-rated tax-free municipal bonds is found in Figure 2.

Third, creating a ladder of short-term bonds will protect you against interest rates rising in the near future. However, whatever kind of bonds you purchase for your short ladder, they will provide only a small return in today's bond market. Since the yield curve is currently very steep, you will receive a lot more return for investing in longer-term bonds than very short-term bonds.

Fourth, keep in mind that every year that passes, the entire bond ladder gets one year shorter. In addition, longer-term bonds provide a greater return and may enable you to reinvest excess cash at a higher rate of return.

Fifth, since we don't know whether interest rates are going up or down, or the timing of such moves, our advice is to get your bond ladder in place as soon as possible. Waiting for interest rates to rise before you establish your bond ladder may result in the loss of a great deal of cash flow while you are waiting, if your timing is not precise.

Our Current Strategy

In the current environment (April 2013), the yield curve is very steep, meaning that long-term bonds yield a great deal more than short-term bonds. In this environment, we suggest the following strategy.

Purchase bonds that are free of federal income tax for your taxable accounts.

All bonds should generally be rated at least AA by Moody's and Standard & Poor's or by at least one of these rating agencies. The bonds should fall into one of the following categories:

- Certain state general obligation bonds generally rated at least AA,
- Certain county and city bonds generally rated at least AA,
- Certain essential services bonds generally rated at least AA or
- Bonds of certain universities generally rated at least AA.

The bonds should be purchased to form a customized bond ladder designed for your financial needs. If you have no special needs, we recommend buying bonds with due dates ranging from 15 to 23 years to maturity with attention paid to first call dates.

Your customized bond ladder of high-quality bonds will result in the following outcomes:

- Preservation of your wealth,
- Creation of a reliable and predictable cash flow,
- Reduction of your federal income taxes and
- Preservation of wealth for your heirs.

Buy Individual Bonds Not Funds

When we speak of bonds, we do not include bond funds. There are many differences between individual bonds and bond funds. The following are a few highlights.

Bond funds are not bonds; they are quasi-equities that don't come due. Individual bonds have a due date. A fund has to sell bonds that no longer meet its objectives and purchase new bonds at current market rates. If interest rates are falling, the bond fund must purchase new bonds at those lower rates. If interest rates are rising and there are many redemptions, the fund must sell bonds into the rising interest rate market in order to meet their redemptions. An alternative is to keep substantial sums in cash earning nothing, which also lowers the fund's returns.

If you purchase bond funds, you are making a bet that interest rates will either stay the same or decline. If interest rates were to rise significantly, you are making a bet that you can time the market—turn and trade out before you lose a great deal of money. By comparison, while individual bonds may have the same market volatility as bond funds, as an individual bond approaches maturity its price will move closer to its face value and its volatility will decrease.

Although you can trade out of a bond fund more easily than individual bonds, since you can hold individual bonds until their maturity and receive a fixed amount (the bond's par value), you will not have to trade them to get your investment back. Trading in and out is expensive and is for professional traders. Individual investors generally find it quite difficult to make two right decisions: when to buy and when to sell. If you sell at a profit, Uncle Sam is the first one to congratulate you and take his share.

It is not possible to determine the cash flow that you will receive on a bond fund because of a number of variables: trading results, future interest rates, expense ratios, trading costs and changes in holdings. Reporting of fund returns varies from fund to fund.

Many bond funds invest in lower-grade (riskier) bonds to stay competitive with other bond funds and to cover their fees and expenses. Some funds are leveraged (use borrowed money) and thus are more volatile than individual bonds. They may be benchmarked to show performance, but the benchmark may itself keep changing. Some funds also use derivatives in the hope of increasing their returns. This will also magnify their losses.

Conclusion

Here are our recommendations for how you should proceed in today's "low" interest rate environment:

Table 1. Tax-Equivalent Yields for 4.00% Muni Bonds

2013 Tax Bracket	Taxable Equivalent Return (%)
33%	5.97
35%	6.15
39.6%	6.62

1. Define your objectives and financial needs. We always can use more, but if you look at the bottom line, you can provide for what you absolutely need and then work for the rest.
2. Determine your asset allocation between how much of your portfolio you wish to keep safe in a custom bond ladder and how much you will use to speculate.
3. Don't worry about timing interest rates in the market—you probably can't anyway.
4. Set up your custom bond ladder now to generate a consistent cash flow.
5. Invest your taxable account in high-quality tax-free municipal bonds.
6. Sit back and relax knowing that if interest rates go up after you establish your bond ladder, that is your upside investment case.

A final and important note for investors in a high tax bracket: The yield to maturity on a long-term high-quality municipal bond in April 2013 is now 4.00%. The tax-free equivalent return for a 4.00% yield to maturity for taxpayers in various tax brackets is displayed in Table 1. These may be attractive returns for high-quality investments if predictions of the so-called "new normal" turn out to be accurate. ➤

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