Is a Bond Bubble About to Burst?

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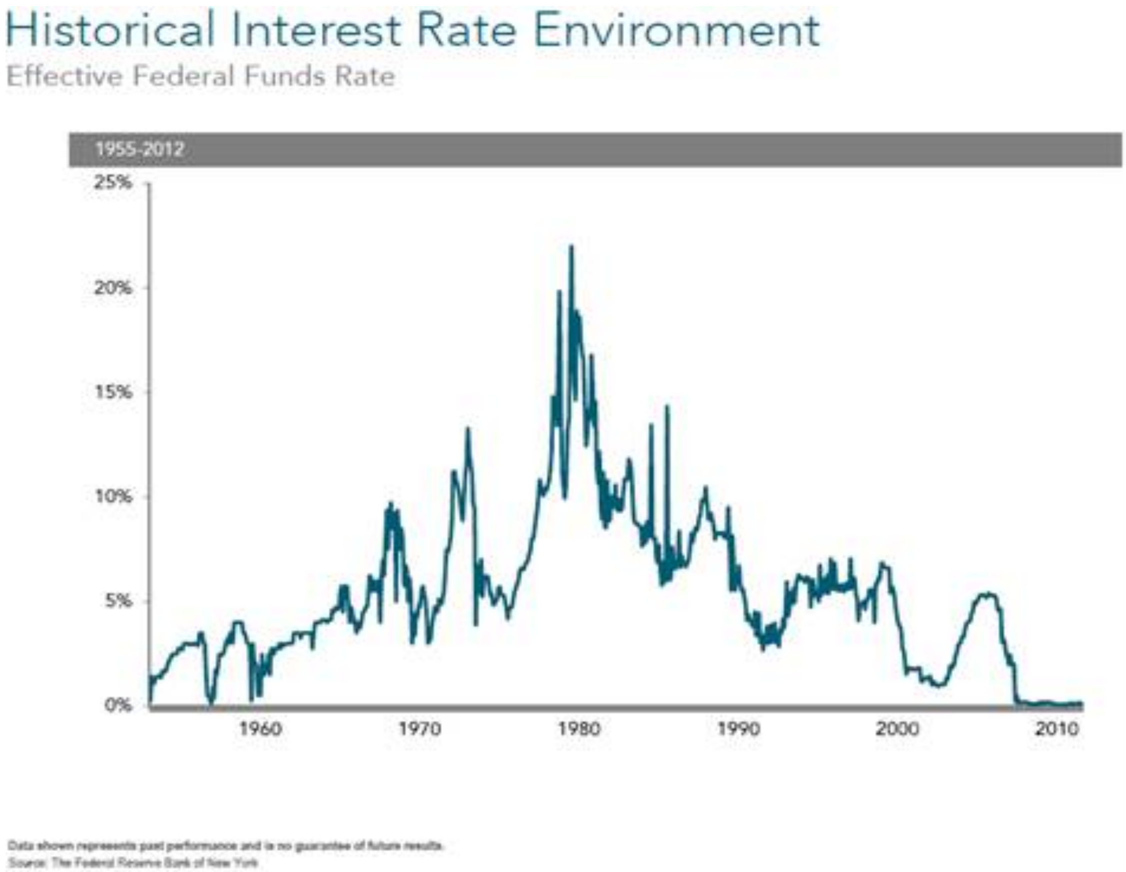
There is no question that those close to or in retirement are being hit with a double whammy. After a period of frustratingly low yields made generating a reliable income stream a challenge, today's rising rates could diminish the value of bond portfolios. The 10-year treasury is at 2.2%, which is a far cry from the 6.5% average since 1962.

Conventional wisdom holds that stock/bond portfolios should be weighted more heavily toward lower risk bonds as investors age, today a bond-heavy portfolio may feel pretty risky. Do the math. Benchmark Treasury yields have been well below 4% since early in the financial crisis. If your portfolio generates under 4%, how can you withdraw the commonly accepted 4% annually, and add inflation adjustments, without seriously depleting your portfolio over time?

What to do? There's no easy answer, but before discussing our options, a quick fixed income refresher course can help you to appreciate fully the complex situation we find ourselves in. The first topic in our Fixed Income 101 is the role bonds play in a portfolio. In short, bonds function as a security blanket to temper the volatility inherent in stocks and other risky assets and help create a reliable income stream.

It's also crucial to understand the inverse relationship between interest rates and bond yields. Simply, when interest rates rise, the fixed income portion of your portfolio may face volatility and loss. The simple rule of thumb is if interest rates increase 1 percentage point (100 basis points), a bond's (or bond fund's) value will drop by approximately the bond's (or the fund's weighted average) duration. Yes, this formula is simplistic because it presumes a rare instantaneous, parallel shift in the yield curve, but it gives you a quick sense of how bonds might perform in a rising interest rate environment.

Finally, to allay your fears of a complete bond meltdown, it's helpful to review some market history. And, because a picture is worth a thousand words, I've been sharing charts such as the one below depicting the "Historical Interest Rate Environment" provided by Dimensional Fund Advisors to provide some context for the unique environment we find ourselves in.



Our history lesson concludes by noting that while the fear of rising interest rates may be legitimate, a potential bear market in bonds is dramatically different from a bear market in stocks. Unlike stocks, where the accepted definition of a bear market is a 20% decline in prices, a bear market in bonds is often defined as any period of negative returns.

In fact, the broad U.S. bond market has never experienced a –20% return. Far from it. In fact, the worst calendar year for the broad bond market was 1994, when due to an unexpected upward shift in interest rates, the bond market returned –2.9%. (Note, however, that in 1995, the bond market bounced back and returned 18.5%.) Contrast this to the experience of stock investors in 2008, when the Standard & Poor's 500 Index lost more than –2.9% in *just 27 trading days*.

Understanding bonds' structure, the math behind the returns, and the significant differential in volatility can help you to feel comfortable maintaining your strategic allocation to fixed income, even as rates rise.

Those looking for protection from rising rates are investing in shorter duration bonds that will be less impacted by interest rate increases. Others, looking to boost chronically low yields are investing in high yield corporate bonds. While these are different bets based on different market outlooks, it's important to remember bonds' main portfolio function. Bonds work as a diversifier to offset the riskier assets in your portfolio. Therefore, diversifying between stocks, bonds and alternatives to stabilize portfolios remains the core of smart portfolio construction. Diversification is the way long-term investors can weather all types of markets. Even bond bubbles.