

The major part of my hands-on investing career has been in the bond markets. My wife will attest that bond people are strange; we get very excited over things that most people could care less about. But every once in a while the bond market becomes interesting, as it did in May and June, and people begin to write about it. At times like this I think it's important to talk straight about bonds.

The most basic question any investor should answer is, "Why invest in bonds?" After all, over long periods high quality stocks return about two times the return on bonds. Added to this is the fact that stocks now have extremely favorable tax treatment, while taxable interest is considered ordinary income. And the return on tax-exempt bonds is only around 4% to 4.5%. The answer to this question is that for the vast majority of people, stocks are too volatile. It is a rare person who could calmly watch a portfolio drop 50% in 2001 and 2002 without reacting. So people incorporate bonds into their portfolio to dampen volatility at such times.

The next thing an investor should understand is not to get excited over moves in bond prices; either up or down. When interest rates fall, bond prices rise and, of course, when rates rise prices fall. In the case of rising bond prices, does that mean the investor is getting a great improvement? The investor could sell, for instance, a 5.5% bond bought at 100 for 103. But, then, what does he do with the money? The answer is, reinvest at 5%. Is this a good deal? It is, at best, questionable. Over time the return on a bond is going to be just about its stated interest rate. The only time I encourage investors to trade bonds is when they can move their funds to another bond not too different from the one they sell, and increase their annual income. The beauty of the market is that moves like this are often possible.

Then there is a term you hear often when people speak about bonds; laddering. The source of laddering is the idea that bonds are really simple, so let's do something really simple. Let's divide your money by ten and invest a tenth each in a one-year, two-year, three-year and so on out to ten-year bond. Then each year you have a maturity that you reinvest at the longest term. I think, for various reasons, that this is dumb. First the bond market is visible. In 2001, the tax-exempt market was a challenge. On a one-year bond you could get just over 2% and in five years, just over 3%. These options made no sense because they would not keep pace with inflation. Around ten years it was possible to get over 4%. So, under the circumstances, why would anyone want to "ladder" a portfolio?

Then there is the selling point that with a ladder you have a maturity every year. So what? The maturity of a bond is truly a non-event. All it means is that you must change your investment. And, as I pointed out above, there are frequent opportunities in the bond market to do that decisively to your advantage.

There is one last point I make about bonds. Throughout my career I have been shown low quality bonds that were offered at "incredible" yields. Back in the '80s these were "junk bonds" yielding around 13%. Today yields on such offerings tend to be lower. I've always thought these yields were truly anemic. That's because I could invest in the stocks of the very finest companies (never having to worry about their survival) and history taught that I could fully expect over time a return of 10% to 12%. So, if I invest in real junk, shouldn't I be paid much more than that?

I am aware that there are many people who approach bonds differently than I, and I've learned that is fine. That is precisely what makes the bond market interesting.

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