GETTING A FIX ON BONDS

The oft-overlooked world of fixed income demands a disciplined investment strategy quite different from the world of equities.

By Amy R. Kover

BUYING A BOND can be the safest investment you make. Or the riskiest. The only thing that separates the two extremes is the bondholder’s state of mind.

Welcome to the wacky world of fixed income, where very little, it turns out, is actually fixed. Higher prices go with lower yields, and both fluctuate constantly. On Wall Street bond traders make and lose fortunes in an afternoon. Long-term bond owners stand oblivious to the tumult.

There are two diametrically opposed reasons to own bonds. The risky one is a play on interest rates: You buy a bond hoping that rates will fall, leaving you with a tidy capital gain as the market value of the bond rises. That’s the business Wall Street institutions focus on, and playing it right can bring huge gains. (See “Can Stocks Still Rise?” for the opportunities Morgan Stanley strategist Barton Biggs sees ahead.) But you can also experience severe losses, especially since predicting the di-
WHICH BONDS TO BUY

WHEN COMPARING YIELDS ON BONDS, one of the key factors to consider is taxes. The worksheet below helps quantify the after-tax yield of different types of bonds with the same maturity, so you can see what you’re getting for each level of risk you’re taking. The corporate bond section can be filled out twice, to compare a high-yield bond with an investment-grade issue.

TREASURIES

1. Enter the current yield to maturity (for rates at auction, call 202-874-4000 or go to www.publicdebt.treas.gov).

2. Enter your federal tax rate, as a decimal (example: 31% would be 0.31).

3. Subtract the amount on line 2 from 1 (example: 1 minus 0.31 equals 0.69).

4. After-tax Treasury yield: Multiply line 1 by line 3.

MUNICIPALS

1. Enter the yield to maturity (for rates, check out the PSA/Bloomberg municipal bond index at www.psa.com).

2. Muni issues outside your home state incur state and local income taxes. Enter your combined state and local tax rate for such purchases, as a decimal (example: 5% would be 0.05). Otherwise enter zero.

3. Subtract the amount on line 2 from 1.


CORPORATES

1. Enter the current yield to maturity.

2. Enter your combined state, local, and federal tax rate, as a decimal.

3. Subtract line 2 from 1.


Correction of interest rates is something even the supposed experts have little consistent success with.

The safer side of bonds—and the one more appropriate for most individual investors—is the traditional course of buying and holding to maturity. If that’s your mindset, the fluctuations in rates that bounce the market value of bonds around like crazy are irrelevant. While you can’t completely ignore how inflation might eat into your purchasing power, you do know that you’ll collect your coupon, and at the end of the road you’ll get your principal back.

It sounds straightforward, but with so many different types of bonds to choose among—from various issuers, with varying maturities—developing a coherent bond strategy can be quite tricky. What follows is a primer on the risk-reward tradeoffs implicit in different types of bonds and bond funds. We’ve also included a worksheet that helps investors quantify the extra yield they’re getting for each step up the risk chain, to better weigh whether moving up makes sense for their needs.

Naturally, our starting point is Treasuries, the benchmark against which other bonds should be measured because default risk is negligible, trading costs are low, and liquidity is high. You step beyond Treasuries only to get a premium yield, in exchange for taking a greater risk. Municipal bonds, which appeal to individuals in higher tax brackets because they are exempt from federal tax, now enjoy only a narrow advantage over Treasuries compared with historical averages: Long-term Treasuries pay a 1.07-percentage-point premium over comparable munis on an untaxed basis, vs. an average spread of 0.89 percentage points since 1950, according to the Leuthold Group, a Minneapolis research firm. Indeed, the premium being paid for risk is narrow all along the bond spectrum, making Treasuries and insured munis the best relative bargains today.

What about bond funds? They aren’t bonds: They don’t pay a fixed yield, your principal isn’t guaranteed, and their interest rate exposure and average maturity constantly fluctuate. But they can be looked at as an entire bond portfolio. In that context, it is not the fund’s current yield that is most important—even though that is the basis on which they are usually marketed—but rather the historical total return of the fund vs. its peers. In fact, high yields are often a sign of danger: “There are no free lunches in the bond world,” says Mark Wright of the fund research firm Morningstar. “If there’s a high yield, it means that the manager is most likely paying out part of your principal and taking on more risk. He’s not necessarily earning you more money.”

We’ve separated the bond world into its three main components—Treasuries, munis, and corporates—detailing potential risks, offering trading tips, and giving insights into what a fund might offer over individual bonds.

TREASURIES

RISKS. The big threat to any long-term bondholder is the combination of rising inflation and rising interest rates. Inflation eats away at the buying power of your principal. Rising interest rates diminish the market value of your bonds, so that if for some reason you couldn’t hold to maturity and had to sell, you’d face a loss.

The solution to both these complications is to build what’s known as a laddered portfolio of Treasuries—a series of bonds with staggered maturities. For instance, you could buy ten bonds, with maturities from one to ten years. Each year, as a bond comes due, you would buy a new ten-year Treasury with the proceeds. “If
interest rates go up, you’re glad you’ve got money coming due to take advantage of the higher rates,” says John Combias, a New Jersey financial planner. “If interest rates go down, you’ve locked in higher rates for ten years.” Your portfolio adjusts if rates rise, and if you need to liquidate some portion of your holdings, you’ll always have some short-term bonds, where the potential losses will be minimal.

**TRADING POINTS.** The cheapest way to buy Treasuries is from the government, via the Treasury Direct program: It’s free, although Treasury Direct accounts of more than $100,000 carry a $25 annual fee. You simply send in a form to the U.S. Treasury. (Forms can be obtained by calling 202-874-4000.)

But cheaper isn’t always better. Because Treasury Direct restricts you to auctions, it would take quite some time to construct a laddered portfolio. Also, Treasury Direct doesn’t have a mechanism for selling; if you need to, you’ll have to go to a broker. Many people may find the convenience of using a broker right from the start worth the extra expense—especially since fees for trading Treasuries run at only around $40 per transaction.

**FUND FACTS.** If you don’t have enough money to construct a ladder, consider a low-cost, plain-vanilla fund such as those run by Vanguard. (Always avoid bond funds with high expense ratios and sales loads.) These funds also have the advantage of offering immediate reinvestment of interest, something you can’t do with actual bonds.

Another fund option is the American Century–Benham Target Maturity series. These funds mimic zero-coupon bonds, actually terminating at a set date. That makes them ideal for those who wish to play interest rates—net asset values jump around with daily swings in the market—but also for long-term investors with fixed expenses ahead, such as college tuition bills. Unfortunately, just as with actual zeros, you owe taxes each year on the accrued interest, even if you haven’t sold your shares.

**MUNICIPALS**

**RISKS.** Despite all the financial troubles that state and local governments have, they rarely default on a bond. Even Orange County, which went bankrupt after a series of catastrophic derivative investments in 1994, has made good on its munis. The greater risk is a downgrade in credit rating. While it has no impact if you hold until maturity, you would take a shot if you unexpectedly needed to cash out. Just last fall Miami’s credit tumbled from investment grade to junk level after the city revealed a major budgetary crisis. Munis are also less liquid than Treasuries.

**FUND FACTS.** If you build a ladder of individual munis—at $25,000 per bond—to diversify your interest rate risk, and also perhaps diversify among locations to limit your downgrade risk, it requires committing a ton of money. Many people don’t have that level of resources, which is what makes low-minimum muni funds attractive. They are also more liquid than actual munis. And you get access to a manager who may be able to play the credit-rating changes of a locality to your advantage. “In a bond fund, what you’re getting is somebody who spends all his waking hours thinking about how to find the best values in the marketplace,” says investment adviser Tim Schindwein, who puts his own clients into muni funds.

**CORPORATES**

**RISK.** Higher rates on corporate bonds may seem enticing, but these days their yield advantage over Treasuries is minimal. Currently a high-grade corporate bond offers a 0.54 percentage point yield—premium to 20-year Treasuries, vs. an average of 0.72 percentage point since 1982. The fact that corporates incur state and local taxes that Treasuries do not further cut into their apparent advantage.

Junk bonds may look better: The spread between the Merrill Lynch high-yield index and 20-year Treasuries is now 2.3 percentage points. Still, there, too, the premium is historically narrow: The average spread since 1982 is 3.66 percentage points.

The chance of a default or downgrade is also much higher with corporates, and especially with high-yield bonds. Plus, there’s the quagmire of call options—devices that allow an issuer to pay off a loan before the maturity date. Say you buy a corporate bond at par (100) with a call option at 105 for the next year. Then interest rates fall, and the bond’s price rallies to 110. If the issuer decides to refinance the debt at the lower rate, it can call the bonds at the lower price, leaving you short $5 per bond. And of course you’ll have to find a new place to reinvest your principal—at now lower prevailing rates.

**TRADING POINTS.** As with munis, corporates carry big face amounts (at least $10,000), so you’ve got to put a lot down to build a portfolio. And they’re none too easy to buy and sell. Brokers’ markups are similar to munis—as high as 3.5%.

**FUND FACTS.** This is one part of the bond world where funds are usually better for individuals than actual bonds. Professional managers usually negotiate cheaper trading costs and are better equipped to watch the market closely, taking advantage of potential upgrades and downgrades in credit ratings, as well as interest rate fluctuations. You may well be better off with a fund than on your own.