Buena Vista Investment Management, LLC

Creative Investment Solutions

BOND FUND INVESTORS MAY BE EXPOSED TO MORE RISK THAN THEY REALIZE

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Bond funds have become incredibly popular with the investors. They pay monthly. They yield much more than CDs or money market funds. They are comprised of several different bonds so that you can get diversification. Plus, they have been a wonderful investment over the last three years. In fact, the returns in bonds from 1980-2010 was the highest return on any financial asset class. Bonds had never led in returns over any other thirty year time frame.

All investments have periods of time where they outperform. With interest rates being at record lows over the last two years, they no longer have very far to go to get to zero. Thus, the question is not what direction rates are going. The question is when are rates going higher and how high do they rise. It becomes very important that investors understand how rising rates will decrease the principal value of their bond funds. If rates go up 1%, a portfolio with an average maturity of three years will see a decline of 2.8% in principal value. If you own a fund with bond maturities between ten years and thirty years, the principal will decline from 8.6% to 19.7% per 1% increase in rates.

It is important that as an investor you understand how bond funds work. People invest money with a manager who then invests it into bonds. There are numerous different styles of bond funds. Funds can vary depending on type of bonds in the portfolio. The bonds in the funds can vary by creditworthiness, geographic location and average maturities of the bonds. The portfolios usually consist of a range of different maturities. Historically, purchases in these funds increase in declining interest rate environments. Highest sales tend to be when interest rates are rising.

The importance of this knowledge is that bond managers have money coming into the fund when bond yields are declining. They must buy bonds at these depressed rates. When rates increase and investors sell their funds, the manager must sell bonds to meet the redemptions. Thus, there is a history of buying high and selling low. Unlike buying an individual bond that has an exact maturity when the principal is returned, bond funds are an ongoing investment. Therefore, the investor's principal is subject to fluctuations.

Interest rates are set based on factors such as credit worthiness, maturity, supply and demand factors, fed funds rate and inflation expectations. The Fed Funds rate has been targeted by the Federal Reserve at 0 to.25% for over 2 ½ years. Inflation, with the increase in oil and fuel prices, is much higher than one year ago. The demand for bonds will be altered without the Federal Reserve purchases, the Japan rebuilding and the Chinese retreat from the market. Newly issued treasury bonds continue to increase in quantity as the deficits soar. These factors point to higher interest rates. If you own bond funds, you may want to consult with your advisor to see how much risk you have if rates go higher. Individual bond portfolios which are laddered from one to four years may be a strong alternate.