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How to Prepare for a Changing Bond Market

The words 'bear market' have been bandied about a lot lately. When you read or hear them, remember to respond the same way you would if you saw an actual bear in the woods – by staying calm and keeping your wits about you. A changing bond market environment creates challenges for investors and financial advisors, but it also creates opportunities.

Bonds and a bear market

Many people believe bonds are risk free. That's not the case. Bonds expose investors to several kinds of risk. These include:

- **Inflation risk**, which is the possibility your savings may grow more slowly than inflation increases.¹
- **Credit risk**, which is the possibility the company issuing a bond will fail to make interest payments and/or repay principal in a timely way.²
- **Interest rate risk**, which is the possibility the value of bond holdings will fall as interest rates rise.³

Interest rate risk is associated with a bear market in bonds. *Barron's* explained it like this:⁴

“Unlike the stock market, where a 20 percent drop in prices is considered the marker of a bear market, there is no consensus about what constitutes a bear market in bonds...To distinguish between temporary spikes and actual bear markets, we think it's reasonable to define a bear market in bonds as a sustained decline in prices (or rise in yields, which move inversely to prices) during a period of tighter monetary policy from the Federal Reserve.”

One reason the definition of a bear market in bonds is poorly specified is because bond rates have trended lower for about 36 years. Since September 1981, when 10-year Treasury bonds reached 15.8 percent, we've been in a bond bull market.^{4,5}

That doesn't mean bond rates haven't fluctuated. *Barron's* reported, at least nine times during the bond bull market, rates increased significantly. In other words, there were times when rates rose and bonds lost value during the bull market in bonds, just as there were times during a bull market in stocks when values fell before rising again.⁴

Bonds and stocks are very different types of investments, though. When investors buy stocks, they become owners of companies. If a company does well, its shares may gain value. If a company performs poorly, its shares may lose value.

When investors put money in bonds, they are lending that money to a government, a company, or another entity. The investor expects to receive timely interest payments and a return of principal when the bond matures.

There is an inverse relationship between bond rates and bond prices. Imagine two children sitting at opposite ends of a seesaw. Typically, when interest rates go up, bond prices fall, and when interest rates go down, bond prices rise.

Challenges and opportunities in a rising rate environment

Currently, we appear to be on the cusp of a period of rising interest rates. The Federal Reserve began encouraging higher rates in December 2015 when it increased the Fed funds rate for the first time in a decade. Since then, the Fed has raised rates six times.^{6, 7}

Early on, the rate on 10-year Treasuries remained stubbornly low despite the Fed's efforts. In fact, it fell below 2 percent following the rate hike and stayed there until November 2016.⁸ This year, bond rates have pushed higher.

As the interest rate environment changes, talk with your financial advisor about the ways they will approach the challenges and opportunities created. Your advisor may employ strategies such as:

- **Rebalancing to maintain a consistent average maturity.** One way to address the risk of rising rates is to include bonds with different maturities in your portfolio. The higher rates on new bonds added to the portfolio may help offset any capital losses caused by rising interest rates.⁹
- **Reducing portfolio duration.** Duration is a measure of a portfolio's sensitivity to changes in interest rates. The longer the duration, the greater the change in price relative to interest rate movement. The shorter the duration, the lesser the change in price relative to interest rate movement. *Barron's* explained:⁴

“A bond with a duration of five years typically will move down in price by about 5 percent for every 100-basis-point increase in interest rates. A bond with a 2-year duration typically will move down by about 2 percent.”

While bond bear markets create challenges, they also create opportunities. For example, investors may have a chance to:

- **Reduce portfolio risk.** During the past decade, investors who sought income shifted assets from historically low-yielding bonds to dividend-paying stocks, lower-rated bonds, and other higher-yielding sectors of the market, according to *T. Rowe Price*. This may have increased the preferred risk level of conservative

investors' portfolios. As bond rates rise, portfolios may be able to meet income objectives by investing in lower-risk bonds.¹⁰

- **Find bargains among dividend stocks.** If investors move out of dividend-paying stocks and into bonds, the prices of some companies' shares may become more attractive, according to *Barron's*.¹¹

Bear markets, whether in stocks, bonds, or another type of investment, make many investors uncomfortable. Two ways to weather any type of bear market are to minimize risk through portfolio positioning and capitalize on opportunities created as the market environment changes.

If you would like to learn more, give us a call.

Sources:

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² <https://www.investopedia.com/terms/c/creditrisk.asp>

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⁹ <https://www.barrons.com/articles/how-to-protect-your-bond-portfolio-against-rising-rates-1524571200> (or go to [https://s3-us-west-2.amazonaws.com/peakcontent/Peak+Documents/Jun_2018_Barrons-How to Protect Your Bond Portfolio Against Rising Rates-Footer 9.pdf](https://s3-us-west-2.amazonaws.com/peakcontent/Peak+Documents/Jun_2018_Barrons-How_to_Protect_Your_Bond_Portfolio_Against_Rising_Rates-Footer_9.pdf))

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