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6 Questions for Bond Buyers

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The stock market has taken us on a wild ride the past few years. So the relative stability of bonds may seem enticing. As you weigh how much bond exposure you want, ask yourself six questions.

Bond investing basics are simple. When you buy a bond, the bond issuer, either a government or corporation, pays you an agreed-upon rate of interest known as the coupon rate. In addition, you get your original investment back when the bond reaches a maturity date.

The questions:

Do you want to go long- or short-term? Normally, longer-term bonds pay higher interest than shorter-term bonds. However, monetary policy and inflation expectations vary with time, so sometimes the normal yield curve may flatten (meaning short- and long-term rates are equal) or invert (short-term rates are higher than long-term rates). When this occurs, it can be very hard to sell a long-term bond because investors can get the same or higher rate investing short-term.

The big questions here are: Where do you want to be on the yield curve? How long do you want to invest your money for a given return on your investment?

How much risk do you want to assume? As interest rates go down, the value of a bond goes up, and when interest rates climb, a bond's value falls. If an investor wants less risk, he might choose to buy a short bond, as its value will fluctuate less when interest rates vary. Long bonds usually offer higher interest rates because they typically carry more risk.

Historically if an investor wants no risk, short-term U.S. Treasuries were always the consensus best choice. After all, Uncle Sam backs them up. But they pay a comparatively low rate of return. Their safety, though, is no longer assured. The burgeoning U.S. debt makes them riskier.

A bond's duration relates to interest rate risk. It is a measurement of how long it will take for the price of a bond to be recouped by internal cash flow paid out by the bond. A debt instrument with one-year duration is not very sensitive to interest rate fluctuations. But a really long bond with 30-year duration will see its value fluctuate sharply with even a small interest rate change. Generally, a bond that pays a higher interest rate and has a longer term will have a higher duration.

As an aside, please note that, although U.S. interest rates are paltry at present: a) They have only one direction to head in the coming years, and that is up; b) other "stable" countries are raising their rates.

How important is the rating to you? Investors usually look to Standard & Poor's or Moody's for bond ratings. Government bonds are perceived as less risky than private sector bonds.

Trouble is, the recent financial upheaval was partly rooted in the ratings agencies' failures. They awarded high ratings to mortgage debt that was rotten. Use them as a guide and not gospel.

Some bond investors do have relatively high-risk appetites, with some even buying high yield, also known as junk, bonds from troubled firms whose ability to make interest payments is in doubt. The riskier a bond, the higher the interest rate investors demand. Junk bonds are known as below investment grade: For S&P, that's everything rated BB+ and below; for Moody's, Ba1 and down.

Do you want a tax-free or taxable bond? Many federal and municipal bonds are tax-exempt to some degree. Their interest rates are lower than those of corporate bonds. You need to compare muni and corporate bond rates on an after-tax basis. You do this by calculating the tax-equivalent yield, which equals the tax-free interest rate divided by (1 minus the investor's federal tax bracket).

Consider two investors. Investor A pays a 25% federal tax rate while Investor B is in the 35% bracket. Should they buy a municipal bond paying 4%, or a highly rated corporate bond paying 6%?

The real question becomes: *What will they take home after taxes?*

They run the numbers on the muni bond. Investor A calculates his after-tax yield as 5.33% (4%/(1- 0.25) = 5.33%). Investor B gets 6.15% (4%/(1- 0.35) = 6.15%) after taxes.

Investor B chooses the muni. Investor A figures out that the tax exemption saves her less, so she selects a corporate bond and pays taxes on it.

What about inflation fears? Inflation is the enemy of bonds, eroding the value of their principal and interest payments. But there are remedies within the bond world. Treasury Inflation Protected Securities (TIPS) are issued by the U.S. Treasury. Their principal depends upon the Consumer Price Index. Their principal increases with inflation and decreases with deflation.

TIPS appeal to investors who fear that inflation could erode the value of their investment. When TIPS mature, you redeem either the securities' original value or their inflation-adjusted value, whichever is greater.

Investors who can tolerate varying interest payments may decide to buy a variable-rate bond. The return on these bonds reflects the general level of inflation, and commonly rises with rising interest rates.

Stocks or bonds? Unlike bonds, stocks have the ability to double or triple. Look at **Apple** (AAPL). But they also can crash, as happened in 2008. Stocks are more transparent than bonds, so bond investors need to do a through analysis before buying.

Still, you have more choices with bonds. The global bond market is approximately $82.2 trillion; the global stock market, only $37 trillion. Clearly there is an abundance of bonds in varieties that investors can find appropriate for their income needs, tax situation, time horizon and risk tolerance.

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