Bonds and Safety

We are in those two weeks before the Super Bowl and few people who know football know what to make of this game. Odds makers are initially making the San Francisco 49ers a 4½ point favorite, but this is sure to change. The great story this year is that the head coaches of the two teams are brothers, John and Jim Harbaugh. It will be an interesting game, if only to observe the “chess match” between siblings.

While there may be favorites in any game, the outcome is unknown until the game is actually played. The “sure thing” is sometimes not the ultimate result. Investing and sporting events can sometimes be similar in this way. Experts may be sure of a particular outcome and often they are surprised by investment markets with a very different outcome. As one sports announcer says: “That’s why they play the game”.

Does Safety Exist?

Regulators make it very difficult to use the word “safe” when communicating with the investing public. They feel the public will hear a promise that things will turn out okay. This is interesting because a bond is a promise of sorts. The investor gives the entity issuing the bond some money and this entity, the issuer, promises to pay interest and give the investor back their money in the future.

A bond seems “safe”, so what might make that promise less than safe? There are some possible outcomes that most people would not characterize as being safe when it comes to bonds. It doesn’t mean that people shouldn’t buy bonds, but rather that they should understand what could happen between the time they give the issuer the money and the date they are supposed to get their money back.

Getting Your Money Back

The first risk the buyer of a bond faces is, will they get their money back? If the issuer of a bond runs into financial difficulties they may not be able to pay the buyer back. If you have heard the word “default” it can be used when a bond issuer cannot pay interest or return an investor’s original investment back to them. Will Rogers once observed, “I am more concerned with the return <u>of</u> my money than the return <u>on</u> my money”.

Buyers of bonds pay very close attention to just how financially sound the issuer, from the US Government to small public companies, might be. The more solid the issuer appears, the safer the buyer is likely to feel in buying the bonds offered by that issuer.

Getting Your Value Back

Even when inflation seems low, it has an impact over time. $1,000 bought more ten years ago (when someone purchased a bond) than $1,000 will buy today (when the bond matures). Inflation can slowly eat at the value of the dollars invested and many investors might not consider that to be "safe".

The Elusive "Good Rate"

Granted it has been a while since we have seen interest rates go up and may be a while longer before we see this again. However, when they do go up everyone owning a bond would like the higher rates on new bonds much more than the lower rate on the bonds they own. It is only natural to want more interest when it becomes available in new bonds.

This higher interest makes the bonds folks own less valuable and if they go to sell them, it is likely that they will be offered less than they paid initially to buy the bonds. Most bond buyers don't think that their bonds going down in value or price makes these bonds "safe", but this is the impact of rising interest rates.

Expensive or Cheap?

Remember the old adage, "Buy low, sell high"? Where it is possible for many people to tell when stock prices are high or low, it is harder for most people to judge when bonds are expensive or cheap. The way I like to do it is to ask, "How many dollars do I have to give an issuer, for that issuer to pay me $1 of interest each year"?

The US Treasury issues a 10 Year Note which pays interest at a rate stated on the note. In the 1980's that rate got up to around 14.7% and recently went as low as about 1.5%. At 14.7% you would only have to pay <u>$6.80</u> to "buy" $1 of interest. However, at 1.5% you would have had to pay <u>$66.67</u> to "buy" that $1 of interest each year.

If you're like me, you are probably thinking that bonds are relatively expensive today. This is not to say that prices can't go higher, still most observers feel that there is not a lot of room for them to do so.

Time Will Tell

Many people thought bonds were expensive in 2008 and given where they had been since the 1980's, they were right. However, bonds in general have provided a very nice return over the past few years and many people found them to be a "safe" investment over that period of time.

In a few years we'll learn whether bonds purchased today can be viewed the same way. Of course all bonds are not created equal and so different bonds offer different opportunities and different risks. In the next issue I'll go out on a limb and suggest some bonds that look more attractive to me in our current economic times.

Bottom Line

Safe is a very problematic word when it comes to the world of investing. The reason is that changes in the economy present different risks at different times. The good news is that these same changes also often present opportunities. Take a few moments to understand what can impact your sense of safety in buying bonds, as described above, and we'll move on to some possible opportunities in the next issue.

Your Feedback

I would love feedback on this newsletter. Future issues may include a host of good ideas, insights, specific steps to take financially, life insights and of course "Wit and Wisdom". Most importantly, I'd like it to be of value to you and to encourage an exchange of great ideas and insights. Please send your feedback to:

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