Why Hold Bonds?

While the month of May turned out to be a good month for stocks, it was anything but for bonds. Nearly all bond categories were down for the month. Bond prices go down when rates go up, but we haven't seen this environment for quite a long time. What we HAVE seen is that bond prices go up when rates go down, and rates have been doing just that since the Reagan Administration. Back in 1982, 10-year Treasuries were paying 15%, and after 30 years of steady decline, they dropped below 2% last year and trended down slightly for the first part of 2013. This remarkable three-decade drop in interest rates has been described as the ultimate bull market in bonds, perhaps the most rewarding period for bond investors in all of investment history.

But it's hard to see how bonds can continue much further on the same trajectory, unless you're predicting that people are going to be willing to pay for the privilege of owning Treasuries. Market prognosticators--whose profession is slightly less reputable than pickpockets or members of Congress--have been predicting for years that rates will go back up, perhaps dramatically, creating losses in the fixed-income part of your portfolio. We saw some early signs that the bull market in bonds might be ending this past month, when Treasury bonds maturing in 10 years or more declined 4% in value in three weeks, as the yield on 10-year Treasuries rose from 1.63% to just over 2.23% before dropping back to 2.12%.

U.S. equities are up, in aggregate, more than 15% this year. So the obvious question is: why should we have (or keep) a portion of your investment portfolio in bonds?

The purpose of bonds in an investment portfolio is not to generate high returns--the past 30 years notwithstanding. Bonds protect against the worst kind of market risk--the times when stocks suddenly, unexpectedly plunge. The last time stocks took a nosedive, in 2008, U.S. equity markets seemed to be sailing toward another year of gains and bond prices were experiencing 30 year lows. Why own bonds in an environment like that? Yet by the end of the year, a mixed portfolio of bonds had achieved a 5.24% positive return, while stocks were losing 37%--meaning bonds outperformed stocks by more than 42 percentage points. In 2000, 2001 and 2002 when stocks dropped 9.11%, 11.89% and 22.10% respectively, bonds rallied to give investors returns of 11.63%, 8.43% and 10.26%. Over time, investors holding bonds enjoy a smoother market ride, and experience fewer losses during market downturns.

More importantly, having bonds (and cash) in your investment portfolio gives you options when (not if) stocks fall. If you need income, you can liquidate the bonds, rather than having to sell stocks at a loss. If the prices of stocks drops to the point where stocks become a screaming buy, you have some money set aside to buy at bargain prices and make up some of the losses.

If and when interest rates reverse themselves, and yields move up, you will experience losses in the bond portion of your portfolio. There are ways for professional investors and bond portfolio managers to reduce this risk--reducing the maturity or duration of the bonds from 10 years to 5 years or less, or holding more cash. But bonds are still your best protection against the unpredictability of stock market returns. We don't know what the markets are going to do next, and so the most prudent course is to keep protecting you against the possibility that another 2002 or 2008 is lurking somewhere around the corner.

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