Investing in Bonds When Interest Rates Are Rising

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With the economy slowly recovering, interest rates are likely to start rising soon. Rates are at rock bottom, so the only way to go is up. The question is when the increases will start, according to most analysts.

Knowing that bond returns tend to fall with rising interest rates, should you consider leaving the bond market and moving all in with equities? Some income-oriented investors, including those who have retired or plan to retire soon, reportedly intend to move out of bonds when rates begin going up.

We do not think that is the optimum response. Bonds continue to play an important role in your portfolio by helping maintain proper diversification and asset allocation levels over the long term, regardless of whether interest rates are rising or falling.

"Even when interest rate movements are up, which is not helpful for bond returns, bonds still crank out just under 4% annual returns," said Dr. Craig L. Israelsen, an associate professor of finance at Brigham Young University, in a recent presentation. "It's hard for me to reconcile how we would bail out on bonds and then accept the risk of stocks in terms of their volatility."

Such a tactical move based on anticipation of lower bond returns violates the basic tenets of diversification and asset allocation, Israelsen said.

Bond returns have been falling for three decades. U.S. Treasury bonds yielded around 14% in 1981, and currently are yielding 2%. Looking back several decades provides a clear illustration of the effect interest rates have on bond returns.

In the 34-year period from 1948 to 1981, interest rates rose steadily and U.S. bonds returned an average 3.83% a year. Interest rates then began a long decline over the 31-year period from 1982 to 2012, and over that period bonds returned an average 8.82% a year. For comparison, U.S. stocks remained at about an 11% annual return rate throughout both periods.

Analysts expect interest rates to turn upward after falling so low, so it's reasonable to believe that bond returns are likely to fall over the next few years. But Israelsen cautions against reacting by dumping bonds in favor of equities.

"Generally speaking, we know that U.S. equities in a 10-year period tend to have two or three down years when they have a negative return," he said. "Bonds since 1970 have had two slight negative returns, so it's strange to me to consider that we would bail out of an asset that almost always has positive nominal returns."

Even when interest rates are on the rise bonds provide a useful source of stability for your overall portfolio, with annual returns near 4% historically. That's why every portfolio should include a mix of U.S. bonds, non-U.S. bonds and inflation-protected bonds, along with equities, real estate, resources and cash, tailored to each person's risk tolerance and time horizon.

Israelsen provides a clear example of why maintaining proper asset allocation is generally more important than selecting specific "winning" investments based on economic or market trends. He compares the performance of portfolios with one asset, two assets and four assets from 1948 to 2012 to show how diversification can smooth out the variables presented by the economy.

The accompanying chart, “Bond Performance in a Portfolio Context,” shows annual returns from three different portfolio mixes under conditions of rising interest rates and declining interest rates.

During the 1948-1981 time period, an all-bond portfolio averaged 3.83% returns annually, while the Standard & Poor’s 500 Index averaged 11% annual gains. Adding a little diversification by creating a two-asset portfolio more than doubled annual returns to 8.52% in the first period and 10.56% in the 1982-2012 period. The two-asset portfolio included 60% large U.S. stocks and 40% bonds.

Further diversification shows similar results: A four-asset portfolio consisting of 40% large U.S. stocks, 20% small U.S. stocks, 30% bonds and 10% cash returned an average 9.52% in the earlier period and 9.99% in the later period.

Bonds on their own produced positive returns, but when combined with equities the returns rose, regardless of which way interest rates were moving. That shows that diversification and asset allocation is more effective in boosting portfolio returns than trying to determine which asset classes may rise and which may fall.

If you are still tempted to go all in with equities, it’s important to realize that the higher volatility of stock returns leads to increased risk, especially if you are close to retirement. “U.S. equities in a 10-year period tend to have two or three down years when they have a negative return,” Israelsen said. “Bonds since 1970 have had two slight negative returns.”

If stocks plummet a year or so before you are going to start withdrawing funds for retirement, it can be difficult to make up for the lost retirement income. And that’s the whole point behind diversification, asset allocation and periodic rebalancing, carried out in the context of your risk tolerance and life goals.

The likelihood that bond returns will decrease in the near future should not tempt you to avoid bonds entirely, but Israelsen does suggest a less drastic reaction. “While I’m not compelled really to avoid bonds, perhaps I might go to a shorter duration bond,” he said. “That’s a reasonable thing.”

The longer the time period until a bond is due to be paid back, the more the bond will lose in value when interest rates rise. Bond funds with duration lower than their benchmark will usually outperform when rates are rising.

Many other factors affect the performance of bonds and bond funds. We can help you understand those factors and help you place bonds in their proper place within your portfolio, no matter the direction of interest rates.