How to Make Money From Bonds

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Article Highlights

- A bond ladder can reduce market and reinvestment risk.
- The yield curve helps determine how to maximize returns within the context of your financial plan.
- Staying in cash can be costly if future rates aren't high enough to offset the lost interest income from postponing bond purchases.

We endorse a buy-and-hold strategy for bonds because, when following such a strategy, you only need to make one right decision: when to buy.

With high-quality bonds, the variations in a bond's price while you hold it are not a serious concern because, unless there is a default, you will be paid both your scheduled interest and the face value of the bond at its due date. Long-term bonds experience greater price swings and thus more visceral discomfort than shorter-term bonds; but the ups and downs of a bond's price should not matter to you if you can hold the bond until it comes due at face value.

When you trade bonds, however, you must make two right decisions to be successful: when to buy and when to sell. We recommend to investors that they avoid market timing and leave this activity to traders who move big positions and watch the trading action all day, every day. Making one right decision of this nature is hard enough; making two is a risky choice.

Of course, there are exceptions to a buy-and-hold strategy. There are certain times when it may be financially necessary or strategically advantageous for you to buy or sell bonds. Understanding the implications of different yield curves, placed in the context of your own particular needs, can provide insight into bond market opportunities. The yield curve can also help you compare one bond to another and decide which specific maturities, among the many alternatives available in the market, make sense for you to buy.

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The Yield Curve

A yield curve is a construct of a chart that plots the interest rates being paid by bonds of the same credit quality but different maturities. In the chart, the interest rate is found on the vertical axis and the maturity on the horizontal axis. In the United States, short-term rates are controlled by the Federal Reserve (the Fed), in part by changing the federal funds rate, the rate at which banks borrow and lend to each other. That, in turn, affects the rates banks pay depositors and charge for loans. The London Interbank Offered Rate (LIBOR) is another reference rate of interbank borrowing rates in London that is widely used as a basis for setting short-term borrowing rates. These rates affect short-term rates, which, in turn, affect economic activity and inflation. Borrowers' and lenders' expectations and economic events control long-term rates. The yield curve is a graphic description of borrowers' and lenders' actions in response to the changes in the costs of doing business.

Experts invariably disagree on the direction of interest rates or on what the shape of the yield curve means for interest rates in the future. Although this disagreement is disappointing, you will still get significant information from studying the yield curve, because it can tell you when to be cautious or when an opportunity may appear. The yield curve will help you decide how to maximize your return within the context of your own personal investment plan.

The yield curve has three classic shapes: ascending (or normal), flat, and inverted.

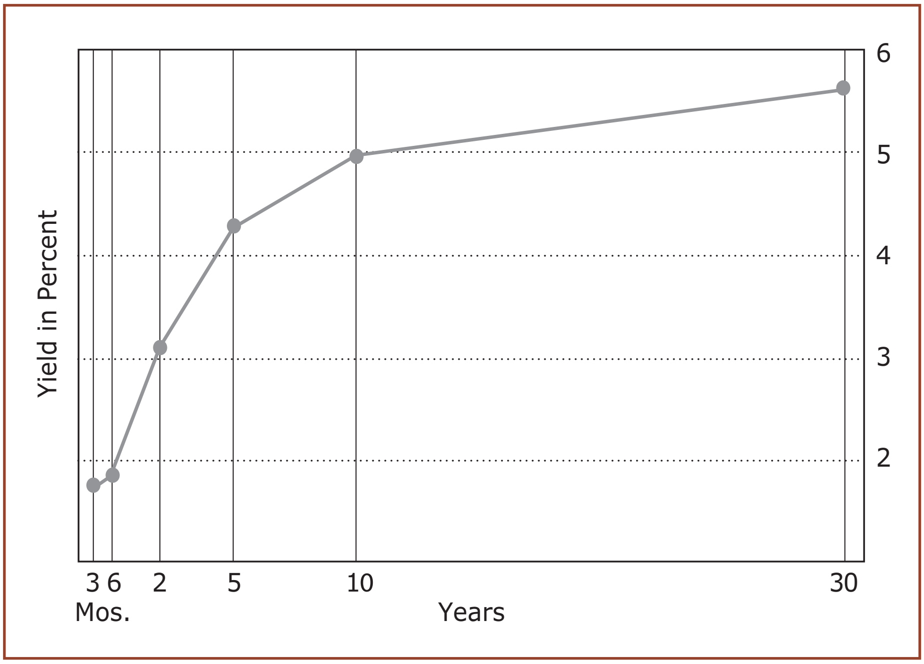
Ascending Yield Curve

In a tranquil world, all yield curves would look like the one that appears in Figure 1. Bonds with the shortest maturities (those on the bottom left) would have the lowest yield (also on the bottom left) because there is less market risk associated with holding them. For long-term bonds, there is more market risk and more uncertainty about the timely payment of interest and repayment of principal and thus additional risk. In this interest rate scenario, bonds with maturities longer than 10 years are more or less lumped together in a benign economic environment, and there is little compensation for purchasing longer bonds.

The greater risk inherent in long-term bonds comes from their price volatility, inflation risk and default risk. Bondholders who take on that extra risk generally are compensated in the form of higher interest rates.

The additional return on longer-term bonds is called the risk premium and is shown in the upper-right part of Figure 1. A steep yield curve is a variant of the ascending yield curve, in that yields increase as the number of years to maturity increases; however, the increase is more dramatic. Short-term yields are really low and long-term rates are much higher. In this situation, the higher yields suggest that you consider extending the maturities of your purchases. Though you may fear that higher interest rates may erode your bond values, it may take many years of much higher interest rates before you break even if you keep your investments short term for what may be an extended period of time.

Figure 1. Ascending Yield Curve



Actionable Strategy: At times when the yield curve is ascending, consider buying longer-term bonds to capture the additional yield while staying within the parameters of your bond ladder (discussed later).

Flat Yield Curve

When the yield curve is flat, you receive more or less the same interest rate whether you buy a short-, intermediate-, or long-term bond. A flat yield curve is transitional. We know that interest rates are going to change sooner rather than later, but we don't know the direction.

Actionable Strategy: At these times, we generally advise investors, within the context of their financial plan, to purchase short-term bonds if they fit into an investor's bond ladder because there is no compensation for taking on the risk of longer-term bonds. If you have enough bonds coming due in the short term, stay in the intermediate range.

Inverted Yield Curve

If there is an inverted yield curve, bonds with a short maturity have a higher yield than long-term bonds (see Figure 2). An inverted yield curve is infrequent and sometimes indicates that a significant economic change is coming, such as a recession. However, this is not always true.

Bond-buying decisions are more difficult when there is an inverted yield curve. If you buy longer-term bonds, you are not being paid for the risk. You can get the highest yield by taking what appears to be the safest path, buying short-term bonds. However, this strategy might have an unfortunate outcome, because the inverted yield curve does not usually last for a long period of time. Short-term yields may rapidly decline, leaving you reinvesting at ever-lower yields. You also miss the opportunity to lock in the yields available in longer maturities, which may look very appealing in hindsight.

Actionable Strategy: Buy short-term bonds if you will need cash soon. If not, consider purchasing bonds within the five- to 10-year range to even out the longer bonds in your ladder.

Strategies for Deciding When to Sell

We do not recommend market timing, but there are many times when it's appropriate to restructure your bond portfolio and sell bonds before they come due.

Monitor the changes that may occur in your marginal federal income tax bracket. A substantial increase or decrease in your federal income tax bracket might lead you to a decision to sell tax-free municipal bonds and purchase taxable bonds, or vice versa.

Check state tax rates if you move from one state to another. A change in your residence from one high-tax state to another high-tax state or from a low-tax state to a high-tax state can trigger a need for a portfolio change to minimize your state taxes. In each of these cases, you might sell municipal bonds sold by issuers in one state and buy municipal bonds sold by issuers in the other state.

Follow changes in the federal tax code. Some municipal bonds are subject to the alternative minimum tax (AMT). They are called AMT bonds. The interest from AMT bonds might increase the federal income taxes of certain taxpayers who are subject to the AMT. Discussion continues in Congress about modifying or abolishing the AMT; any tinkering with it could affect the desirability of owning or the decision to sell AMT bonds.

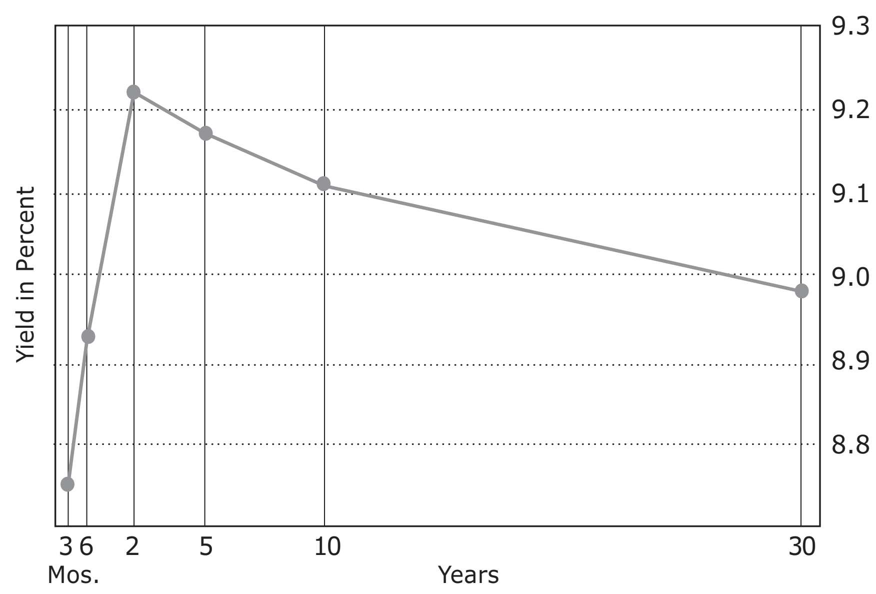
Profit from price gains. Consider selling a shorter-term bond if you have a substantial gain from credit improvement or interest rates moving downward. At that point, you might want to purchase longer-term bonds to generate more cash flow.

Strategies for Finding Bargain Bonds

When the general level of interest rates changes, short-, intermediate- and long-term bonds may move in the same direction. However, one bond sector may become relatively cheap compared to others as a result of the supply and demand for that sector.

Study the Treasury bond yield curve. Determine the most desirable maturity range based on the relative returns and your financial needs. Suppose you were considering the purchase of a bond with a five-year maturity. You might find that purchasing a bond in a longer or shorter maturity might provide a better return as well as support your particular situation.

Figure 2. Inverted Yield Curve



Compare the Treasury yields to tax-exempt municipal bond yields. Even if you are in a lower marginal income tax bracket, municipal bonds might make sense for you if their yields approach those of Treasuries. If yields on tax-free municipal bonds are greater than 90% of Treasuries, the municipals would be a good buy, because they yield almost as much as or more than Treasuries and the income is free of federal income tax.

When buying corporate bonds, compare the returns of sub-sectors in the same maturities. All corporate bonds do not move in unison. Usually, corporate bond yields will skyrocket when issuers have difficulty refinancing and the likelihood of default increases.

Strategies for Avoiding Overvalued Bonds

Just as there are periodic bond-buying opportunities, there are also bond-avoidance situations—times when one or more sectors may be relatively expensive.

Compare the Treasury yield curve to the yield curve of other taxable credit sectors. Professional bond traders always speak of the yield above Treasuries as a way to describe how a bond is priced. If you don't feel that a bond you are considering has enough of a return over the Treasury yield, don't take the risk and buy the Treasury instead. Compare the Treasury to other high-quality bonds and then to lower-quality bonds to determine how the bonds stack up.

Watch out for junk bonds. The yield spreads indicate the market's perception of corporate strength, and they fluctuate based on rumor and market news. If a yield looks too good to be true, it probably is. When the yield spread between Treasuries and junk bonds moves to within 200 basis points (2%), it is an indication that junk bonds are comparatively expensive and should be avoided.

Compare maturities. If the yield curve is relatively flat, there is little or no risk premium being offered for buying longer-term bonds. As a general rule, you want to be in medium-term maturities if you are not getting enough return to warrant longer-term bonds.

Compare asset sectors among corporate bonds. Some sectors are often cheaper as a result of market news, but they may not have been repriced yet to reflect the increased risk. When a sector is being flailed by the media, prices drop substantially.

Strategies for Low or Falling Interest Rates

We love it when interest rates are rising. However, as long as you think strategically, there is also money to be made when rates are falling. Here are some suggestions.

Don't stay in cash. When interest rates are low, you may believe that it would be best to keep your money in a low-yielding money market fund and wait for interest rates to rise. Although this strategy may work out well, many other times staying in cash may prove costly because the longer you wait for rates to go up, the higher the rates must go to compensate you for waiting and earning lower returns. Even if rates do move up later, they must move up enough not only to make up for the lost interest but also to make up for the risk that the rates may not rise, but might fall. Staying in cash is a type of market timing.

Buy EE bonds. EE savings bonds allow you to lock in the current return being paid by the Treasury for 20 years without losing any principal or accrued interest. If interest rates kick up in the future, you can redeem your EE bonds, take your gain, and then buy higher-yielding bonds.

Take a capital gain. Although we generally believe in a buy and hold philosophy, when interest rates are low or falling consider selling some of your bonds to take a capital gain. This strategy works well if you intend to invest the proceeds in another asset class, such as equities or real estate, or have a need for cash for a personal expenditure, such as buying or improving your home.

Consider the secondary market. Investigate the secondary bond market for previously owned bonds. When interest rates are falling, you might consider buying bonds in the secondary market rather than new issues. New issues, being price leaders, may have lower yields at these times.

Buy "kicker bonds." Kicker bonds provide you with a favorable rate to the short call date (the yield-to-call). If they are not called, they "kick" to a higher yield-to-maturity.

Construct a barbell portfolio. In this structure, you split your portfolio between long- and short-term bonds (each constituting one part of the barbell). In doing so, you capture the higher returns of 20- to 30-year long-term bonds and their gains if interest rates decline, while having ready access to the cash in short-term bonds that have maturities of two years or less. The combination of long-term and short-term bonds provides an intermediate-term average maturity and portfolio duration, which may be higher than the return on the intermediate-term bonds.

Strategies for Reducing Market Risk

There are always many investors who are concerned that inflation will rise significantly in the near term, resulting in a rise in interest rates and a substantial decline in the value of long-term bonds. One strategy to deal with this concern is to buy short-term bonds, rather than long-term bonds. These investors equate short-term bonds with safety and longer-term bonds with greater risk. However, by choosing to purchase short-term bonds rather than longer-term bonds, you give up:

- Higher current cash flow generated from higher-coupon bonds. Although you can get high coupons in short-term bonds, these bonds will sell at a high premium.
- Higher yield-to-maturity, which is not available in shorter-term bonds.
- Compounding your investment dollars at a higher rate of return.

The fluctuation of interest rates provides opportunities if you have cash to reinvest. If you have a bond ladder, then you will always have some principal returned to you each year or so. If you can hold your bonds to maturity, then market volatility is not a problem, it is an opportunity.

Implementing a Bond Ladder

Rather than buying only short-term bonds, a better approach to reduce market risk and reinvestment risk is to design and implement a bond ladder.

A bond ladder is a powerful risk-reduction technique that will smooth out the overall interest rate you earn on your portfolio. Laddering a portfolio means you buy and hold a number of different bonds that will come due over a period of years. The period might range from two to 30 years, or any period in between. When the shortest bond in the ladder comes due, it is replaced with a bond of an equal amount at the longer end of the bond ladder.

Let us look at an oversimplified bond ladder. If you want to invest $100,000 in a bond ladder over a five-year period, you might buy $20,000 of bonds coming due in each of five years. When the first $20,000 bond comes due in 2011, you would buy another five-year $20,000 bond coming due in 2016, thus extending your ladder by one year.

The bond ladder is a flexible strategy that can take into account both the structure of the yield curve and your own particular cash flow needs. If you have a particular expense, you can customize your ladder to target particular years so that the required money will be available for each year. There is no requirement that equal amounts come due in each year of the bond ladder. Additionally, your bond ladder can be structured to maximize your income flow. The shape of the yield curve can help guide your purchases.

A laddered portfolio of bonds has several advantages:

- It averages the rates of interest that you earn over a period of years. A ladder provides more overall return in a rising interest rate market because if interest rates are rising, you will replace lower-yielding bonds that come due with higher-yielding, longer-term bonds.
- A ladder reduces duration and results in less market risk than investing only in longer-term bonds. You will be less sensitive to price swings.
- A ladder provides flexibility by giving you access to your funds on a regular basis, because some bonds come due each year or period selected, without the cost of selling.

It allows you to buy some longer-term bonds without undue market risk because shorter-term bonds will come due if you need cash.

In short, laddering is a strategy for individual investors who know they cannot predict where interest rates may go. It produces a steady, predictable stream of income that can pay more than a strategy based only on short-term or long-term investments.

When designing a ladder, take into account all your investments in all your accounts, including money market funds, bank CDs and savings bonds. Don't make the mistake of having a separate ladder in your taxable account and another, similar ladder in your tax-sheltered retirement account. You should design one ladder that reflects all your accounts, while keeping in mind your cash flow needs and the restrictions on distributions from your retirement accounts.

Once you have your ladder in place, don't worry about the daily value of your bonds in good or bad times, unless you observe quality deterioration of a bond. Unless you are going to sell your bonds prior to maturity, market fluctuations don't matter if you can hold your bonds until their due dates. In a so-called bear market for bonds (when interest rates are going up and the price of bonds is going down), you can reinvest the cash from your ladder at higher rates. In a so-called bull market for bonds (when interest rates are going down and the price of bonds is going up), you can take capital gains and buy more bonds with the proceeds.

We take laddering one step further and recommend that investors use a custom bond ladder so that bonds are purchased to come due over a period of years, with the amounts of bonds coming due in different years set to match the amounts needed to meet an investor's financial objectives and needs.

Your decisions about how to structure your ladder should blend your personal cash flow needs and where the yield curve indicates you can get the highest yield. The design of your bond ladder can take into account your concern about interest rates and your need for cash flow and liquidity. Specifically, with respect to the shape of the yield curve, you can employ the following strategies:

- If the yield curve is flat, you might want to keep your ladder between one and 10 years. You are not being paid to take on the additional risk of longer-term bonds. You also might be cautious about buying very short-term bonds because interest rates may fall.
- If the yield curve is ascending and steep, you might prefer a five- to 20-year ladder. If you keep your maturities near five years, you will earn very little on your money. If you purchase maturities that are longer, you will be able to increase your return.
- If the yield curve is inverted, you might consider purchasing intermediate-term bonds unless you have a need for short-term cash soon. If you purchase only short-term bonds, you may find yourself reinvesting at much lower rates.

If you have your bond ladder in place and if inflation occurs, resulting in rising interest rates, it will be the upside case for you: As your bonds come due you will be able to reinvest the proceeds in higher-yielding bonds.

Conclusion

There are multiple strategies for you to employ when you invest in bonds. This article has provided a sampling of some of these techniques from our book "Bonds: The Unbeaten Path to Secure Investment Growth," Second Edition (John Wiley & Sons, 2011). The most powerful of these strategies is to design and implement a custom bond ladder structured with your financial needs in mind.

A bond ladder will reduce your interest rate risk. By focusing on the yield curve and your own financial situation, you can determine where the most profitable sector of the bond market is for you. You will disregard financial reports of bond values rising and falling because you know you will be able to hold your position until your bonds come due. In our practice a major part of our work is to guide investors in the design and implementation of a custom bond ladder to satisfy their particular financial needs and cash flow requirements.

When you know that you don't know what the direction of interest rates will be, a bond ladder will enable you to deal with this major uncertainty in bond investing. Once your bond ladder is in place, you will be able to relax and enjoy your cash flow—the key to all financial and retirement planning.

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