Scarsdale Investment Group

The Unbeaten Path to Secure Investment Growth

Bonds: A Strategy for Volatility and Rising Interest Rates

Hildy & Stan Richelson
February 22, 2018

Welcome to 2018, a year that woke up volatility and increased interest rates, much to the surprise of many investors and financial institutions as well. This volatility raises the question of what to do now in the bond market?

The answer is shaped by your bond investment strategy. We will compare the buy and sell strategy promoted by the broker-dealers, to a buy and hold strategy based on cash flow.

The Buy and Sell Strategy

You may look at your individual bond portfolio as just ballast against a decline in the stock market. Historically, when stocks went into a downdraft, interest rates went down and thus the value of bonds went up. Thus, bonds served as a true hedge against a decline in the stock market. If you are trading stocks and bonds then this is important to you.

As part of this strategy, you may keep short-term bond funds, mutual or ETF. Your assumption is that you can liquidate the bond funds to support your retirement if you do not want to sell stock. Theoretically, packaged bonds provide support for your cash needs. With the Fed having raised short-term interest rates and slated for more increases in the Fed Funds rate, short-term interest rates have popped up and the value of the bonds have declined. What might have been considered 'safe' money is now showing losses. If you own a bond fund, then these are realized losses when you liquidate the fund.

In 2018 this buy and sell strategy is not working as planned. If interest rates continue to rise, bond funds will not be a hedge for your stock portfolio and you may have losses in both your stocks and bonds. Thus, if you believe that interest rates will continue to rise, you might consider selling some or all of your bonds. The problem is that money market rates are still inconsequential and cash is idle. Trading costs can pile up.

Buy and Hold Strategy

However, we do have a strategy that has worked well over many years in fluctuating bond markets. For this strategy to work, you must break the paradigm of viewing bonds as trading vehicles (like stocks).

Individual bonds come due and self-liquidate. All other asset classes never come due. They must be sold at a market price.

Growth from individual bonds comes from:

- absence of realized loss
- elimination of trading costs
- elimination of transaction costs
- elimination of other investment costs, such as management fees, 12b-1 fees, and so forth
- compounding of the interest income

Unlike any other investment, bonds pay interest regularly. Individual bonds self-liquidate at their maturity date or call date.

Our strategy is to ignore the gains and losses of bonds resulting from the movement of interest rates, and only look at the CASH FLOW.

The cash flow from bonds doesn't change while the bond is outstanding since the coupon rate is fixed. If you buy a $100 bond that has a 3% coupon, you will get $3 every year no matter what is happening in the market to interest rates. Remember, you will get back the face value of your bonds when they come due or are called.

You may be concerned about the impact of rising interest rates on the value of your portfolio. If you have a bond ladder and interest rates do go up, this is your upside case, since you can thus reinvest in new bonds at a higher rate when your bonds are called or come due. This is income averaging into higher returns.

The markets can be dissected into a series of frames in which you are asked to take an action in each one – buy and sell. Or the markets can be viewed as a movie-like continuum where you only take an action when you are ready to break the flow - when your bonds come due, when you have more interest to invest, when cash has accumulated - when you can see a clear advantage.

If you would like a free consultation with respect to how this strategy might work in your particular financial situation, please call or write us.

Stan.richelson@comcast.net – 215-646-8768 Hildy@allbondportfolios.com 215-646-7693