Maximizing Your Profits When Investing in Bonds

by Hildy Richelson

Investments in bonds have grown significantly since stocks peaked in March 2000. Investors now understand that they can make money with bonds, and that bonds, just like stocks, are an essential part of an investment program. Some of the advantages that bonds can provide include: preservation of principal, predictable interest payments and price appreciation from trading.
So let's get down to the nitty-gritty: making money from bonds. In this article, we'll take a look at a variety of techniques and strategies that will help you know when to buy and sell bonds.

Timing vs. Buy and Hold

There are two types of bond buyers: those who engage in a buy-and-hold strategy and those who try to time the market. We view the former as investors and the latter as speculators. By their very description, those in the first group buy bonds and, in the absence of personal financial or strategic reasons to sell, hold them until they come due. Market timers, on the other hand, seek to anticipate interest rate movements and then capitalize on short-term market swings by a strategy of in-and-out trading.

There is little evidence that the top pros can consistently guess the winner of next year's Super Bowl, much less the direction of interest rates. If the world has yet to produce an individual who can accurately and consistently predict the future, what is the prospect that you or your broker can? Even if, through sheer random luck, you do properly guess the direction of interest rates, you still must overcome the dual costs of trading spreads and taxes on the gain.

We particularly like a buy-and-hold strategy because you only need to make one right decision—when to buy. The variations in a bond's price while you hold it are not very important because you will be paid both your scheduled interest and the face value of the bond at its due date. By comparison, when you trade bonds you must make two right decisions to be successful: when to buy and when to sell.

We recommend that individual investors 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 is hard; making two is even harder.

The Yield Curve

However, there are certain times when it may be financially necessary or strategically advantageous for you to buy or sell bonds. Although it's not easy to spot buying opportunities in the bond market, there is a tool—known as the yield curve—that is widely used to discover such opportunities.

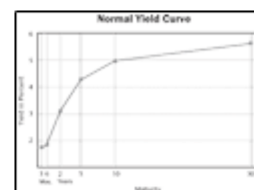
A yield curve is the name given to a chart that plots the interest rates being paid by bonds of the same credit quality but different maturities. In the chart, the interest rate is found on the vertical axis and the maturity on the horizontal axis. Short-term rates reflect investors' perception of near-term events. When they fall, they reflect investors' desire to stay liquid and safe. Long-term rates reflect investors' view of the more distant future. Rising longer-term rates reflect a fear of uncertainty and inflationary pressures.

The experts can agree neither on which way interest rates will go next nor on what the shape of the yield curve means for interest rates in the future. Although this is disappointing, you will still get significant information from studying the yield curve because it can tell you where to be careful and where an advantage may lie at a particular point in time.

The yield curve has three classic shapes: normal, flat, and inverted. Each, as depicted in the actual examples below, tells a different story:

- ***Normal yield curve.*** In a tranquil world, all yield curves would look like this. Bonds with the shortest maturities would have the lowest yield because there is less risk associated with holding them. As the years to maturity stretch out, this creates more uncertainty and additional risk. The greater risk of long-term bonds comes from their greater volatility, inflation risk, and default risk. Bondholders are paid for this extra risk 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 the chart.

Figure 1.
Normal Yield Curve



- ***Flat yield curve.*** If there is a flat yield curve, you receive more or less the same interest rate whether you buy a short-, intermediate-, or long-term bond. In this case, we generally advise investors to stay in the intermediate range due to greater market uncertainty about long-term bonds. It is not unusual for there to be a normal yield curve for, say, the first 10 years and then a flatter yield curve from year 10 to year 30. In this case, it usually makes sense to buy bonds with maturities only as far out on the yield curve as is comfortable until it flattens, because after this point you are not being paid for the risk of the longer-term bonds.

- ***Inverted yield curve.*** If there is an inverted yield curve, bonds with a short maturity have a higher yield than long-term bonds. An inverted yield curve is infrequent and sometimes indicates that a significant economic change is coming, such as a recession. Bond-buying decisions are more difficult under these conditions. 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 long. Short-term yields may rapidly decline, leaving you averaging down to ever-lower yields. You also miss the opportunity to lock in higher yields available in longer maturities. For example, in the early 1980s all interest rates were sky high, and the yield curve was steeply inverted. During this period many very conservative CD buyers bought six-month CDs and kept rolling them over. Unfortunately for them, they missed a huge buying opportunity to lock in long-term Treasury bonds yielding 15%.

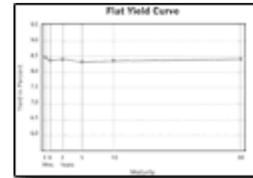


Figure 2.
Flat Yield Curve

Finding Bargain Bonds

When the general level of interest rates goes up or down, most bond sectors usually follow. However, a bond sector may become relatively cheap compared to others as a result of the supply and demand for that sector. How can you find these bargains?

Study the Treasury bond yield curve. Determine the most desirable maturity range based upon your needs. Suppose you were considering purchasing a bond with a five-year maturity. You might find that purchasing a bond in a longer or shorter maturity might yield more. Also, compare the yields on outstanding Treasury bills, notes, and bonds in the same maturity. These securities might yield a little more than more recently issued securities.

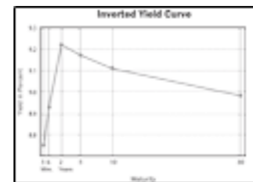


Figure 3.
Inverted Yield Curve

Maybe you wanted to purchase a longer-term bond. The large projected federal government surplus and the government buy-back of 30-year Treasuries resulted in a sharp decrease in the yield of long-term Treasuries in 2000. Shorter maturities that were not actively traded yielded more.

Compare the Treasury yields to tax-exempt municipal yields. Even if you are in a lower tax bracket, municipal bonds might make sense for you if their yields approach those of Treasuries.

Much historical data supports the premise that, on average, the yields on tax-free municipal bonds are 80% to 90% of Treasury bonds for similarly dated maturities. Thus, if yields on tax-free municipal bonds are greater than 90% of Treasuries, as they were for a time in 1986 and 2000, the municipals are considered a good buy because they yield almost as much as Treasuries and the income is tax free. In this situation, even taxpayers in the lowest tax bracket will benefit from munis.

When buying corporate bonds, compare the returns of subsectors in the same maturities. All corporate bonds do not move in unison. By comparing the yields of automobiles to rail companies, for example, you will understand that there is a yield differential for similarly rated bonds in different market sectors. For example, junk bonds became relatively cheap in 1989, 1990, and 2001 because of actual defaults and the threat of more of the same caused by recessions in those years. Junk bonds became a buy after the yields had increased significantly and the threat of default had subsided.

Look for hammered credits that look promising. When Washington, D.C., and New York City ratings were upgraded, those bonds were recognized as safer, and the price rose. It helps if the bonds are insured, just in case your best guess turns out to be a mistake.

Avoiding Overcalculations

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 market sectors. Professional bond traders always speak of the yield above Treasuries as a way to describe how a bond is priced. If you are not getting a satisfactory risk premium above the Treasury yield, don't take the risk. The Treasury bond yield curve is published daily in the Wall Street Journal. Also, check out www.ratecurve.com or www.bloomberg.com for interesting on-line displays that list the yields and spreads between maturities of Treasuries.

The large supply of investment-grade corporate bonds issued in 2001 caused an increase in their yield so that the spread between Treasuries and corporates widened, presenting what appeared to be a buying opportunity, although Bill Gross of PIMCO Funds had sounded an alarm. By early 2002, we found out that he was on target because prices deteriorated due to accounting and management scandals.

Watch out for junk bonds. When the yield spread between Treasuries and junk bonds moves to within 200 basis points (2%), this is an indication that junk bonds are comparatively expensive unless they are an improving credit.

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 short- or intermediate-term maturities if you are not getting enough interest to warrant longer-term bonds. If the yield curve is steep and you do not need access to your principal, buy bonds coming due 10 years or more to lock in higher returns.

Compare asset classes among corporate bonds. Some sectors should be cheaper due to market news, but they may not have been repriced yet to reflect the increased risk. When a sector is being flailed, prices drop substantially.
Ask questions about corporate bond yield spreads over Treasuries. 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 Rates are Rising
We always love it when interest rates are rising because it creates wonderful opportunities for investing money at higher rates and increasing our income. When the commentators say it is a bad time for bonds because rates are rising and prices are falling, you should say, let the bad times roll.

Quickly invest your cash. If you hold cash or cash equivalents, you can now invest the cash at a more favorable rate of return than when rates were lower. This can only be good news.

Consider cashing in your bank CDs. This strategy holds true only for a bank CD purchased from a bank and not for one obtained from a broker.
If you hold a CD purchased directly from a bank, take advantage of the fact that the principal of the CD never goes down. If interest rates have risen significantly, you might cash in your bank CD, pay the penalty, and then reinvest your cash in a higher-yielding and just as safe investment such as an intermediate-term Treasury, agency security, or even another five-year CD. To discourage this strategy, some banks charge one year's interest or more. In fact, the penalty might be higher than the interest that you earned and thus will reduce your principal. Check with your bank on the withdrawal penalties before you invest.

Cash in savings bonds that have been held for six or more months. If you hold EE or I savings bonds, you can cash them in after you hold them for six months. If you hold them for less than five years, you will pay a penalty equal to three months' interest, but if you hold them for more than five years there is no penalty. The key point here is that you never lose any of the amount you invested or the accrued interest with a savings bond (except possibly the three-month penalty). Thus, if interest rates have risen significantly you can cash in your savings bonds and earn even more income by reinvesting in safe but higher-yielding fixed-income investments.

Buy new issues. When rates are rising, you might consider buying new issues because new issues are price leaders. The brokers are hoping they will not have to take a loss on their existing inventory and thus do not mark down their price readily. New issues are priced at the current market value. However, when most investors rush to buy new issues, the better buys may be elsewhere. That's the market at work.

Inflation-protected bonds such as TIPS and I savings bonds sold individually or through a fund appear to be a good hedge when rates are rising. If rising interest rates are a result of inflation, your Treasury Inflation-Protected Securities, or TIPS, and I savings bonds will generally increase in value.

Swap your bonds. There are many opportunities to swap your bonds, although it is better to sell 25 bonds or more to get a better price. Three kinds of swaps are suggested below:

- Swap short-term bonds for intermediate- or long-term bonds to lock in higher returns. If the maturity date on a bond is two years or less, sell and buy an intermediate- to longer-term bond to lock in higher returns. You may either take a gain or sell at a small loss. While selling at a loss might not initially seem like a great idea, keep in mind that your loss will be small because the bonds that you are selling will come due within two years and are thus priced close to their face value.
- Do a tax swap and take a tax loss. This is a trading strategy that is applied to one-up the tax collector. It involves selling low-interest bonds that you own to generate a tax loss and simultaneously buying new bonds to lock in the same or a higher return. In the 1970s when interest rates were constantly rising, tax swaps were considered every year. In fact, the last quarter of the year was called the tax-swapping season.
- Upgrade your credit quality. Swaps can be done to upgrade the credit quality of your portfolio by swapping a weaker credit for a stronger one at a time when the spread between better credits and weaker credits has narrowed.

Pay attention to the yield curve. If the yield curve is steep, buy longer-term bonds gradually to keep your cash flow up, while keeping a reserve for later investment.

When Rates are Falling

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

Don't stay in cash. When interest rates are low, you may believe that it will be best to keep your money in a low-yielding money market fund and wait for interest rates to rise. While 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 rates. For example, if money market rates are 2% and five-year bond rates are 4%, if rates stay the same, you have lost 2% for the period involved. 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. Staying in cash is a type of market timing and is unlikely to work out favorably over the long term.

Take a capital gain. When interest rates are low or are falling, consider selling some of your bonds to take a capital gain. The only time you should use this strategy is 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. There is no advantage in taking a capital gain and then investing in similar bonds. This will just increase your tax bill, and your interest rate bet may backfire.

Buy EE savings bonds and convert to HH bonds after six months. You can use this strategy in place of a money market account if interest rates remain low. In 2001 the HH bond rate was 4%, considerably higher than the rate on a money market account. When interest rates go up, you can redeem your HH bonds without the risk of loss of principal.

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

Consider constructing a barbell portfolio. Many financial advisers advocate using what is called a barbell structure for a portfolio if you want to concentrate a significant part of your bond portfolio in long-term bonds. 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. When interest rates are low, investors flock to intermediate-term bonds, pushing the yields of these bonds down. In this environment you might increase the yield of your bond portfolio by using a barbell structure because the prices of short- and long-term bonds may provide better prices and thus more favorable yields to a buy-and-hold investor.
If you are a trader, a barbell will provide gains for you if long-term yields decline and you can sell your long-term bonds at a gain. If the long-term interest rates go up, the substantial short-term bond position would cushion the decline in the value of your portfolio. However, keep in mind that if you guess wrong, you may take substantial losses.

Buy bond funds with longer-term maturities. When interest rates are falling, longer-term bond funds will give you the highest total return. For the adventurous, consider target maturity funds and

long-term corporate bond funds. For the more conservative, consider long-term Treasury or municipal bond funds. Rates right now are at a 40-year low, but are average for the last 80 years. We are only smart in hindsight.

Avoiding Default Risk

When investors think of risk, the main risk that many consider is default risk—when an issuer goes bankrupt and they lose their investment. A default might be caused by bad times in an industry or problems that are specific to the issuer. However, there are ways to stay away from this risk. Here's how.

Buy only bonds rated single-A or better and determine when the bond was last rated by the rating agency. In general, ratings by the major rating agencies are often good predictors of the likelihood of a default. However, if the rating was done years ago, it may not reflect the current financial position of the issuer. Ask your broker not only for the rating of the bond, but also for the date the bond was last rated and by which rating agency.

Purchase bonds that are insured by a highly rated insurer or have some other credit enhancement that you can understand. Bond insurers are only as good as their asset base and can get overextended. If a credit agency downgrades a bond insurer, all the bonds that it insures will be downgraded as well. Thus, if you buy a portfolio of insured municipal bonds, vary your holdings so that different municipal insurance companies are represented in order to provide diversity.

Diversify, diversify, diversify. Diversification is a good way to minimize the risk to your portfolio. Diversify your holdings by issuer and, where applicable, by geographic region and market sector. If you don't have the minimum $50,000 we consider adequate to buy a sufficiently diversified bond portfolio, buy bond funds.

Include different geographic regions in your municipal bond portfolio, even if you are in a high tax state.While you may pay something extra in taxes, this protects you from the economic impact of regional downturns.

Think twice about an investment in a sector, market, or region that is getting bad press. Take some time to consider if the extra yield is worth the extra risk.

Reducing Market Risk

With the exception of money market funds, CDs, and savings bonds, all bonds are subject to market risk, whether they are Treasury bonds or junk bonds. The principal cause of a price decline caused by market risk is generally a rise in interest rates.

Use a bond ladder to reduce market risk and reinvestment risk. A bond ladder is a powerful risk-reduction technique that will smooth out the interest rate that you earn and thus reduce reinvestment risk. Laddering a portfolio means that you buy and hold fairly equal face amounts of bonds that will come due over a period of years. The period might range from five to 20 years. When the first bond comes due, it is replaced with a bond of an equal amount at the longer end of the maturity ladder.
For example, you want to invest $100,000 in a bond ladder over a 10-year period beginning with the year 2005. In this case you would buy $10,000 of bonds coming due in each year starting with 2005 and ending in 2014. When the first $10,000 bond came due in 2005, you would buy a $10,000 bond coming due in 2015. If you have a particular expense such as college tuition, you can modify your ladder to target particular years so that the required tuition money would be available for each year. This is called income matching.
A laddered portfolio 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 than a single bond. It provides less market risk than investing only in longer-term bonds. It provides flexibility by giving you access to your funds (because some bonds will come due each year) without the cost of selling a longer-term bond. When constructing a ladder, take into account all your investments, including money market funds, bank CDs, and savings bonds. Once you have your ladder, don't worry about the current value of your bonds, unless you are looking for signs of quality deterioration. Unless you are going to sell, market fluctuations don't matter. In a so-called bear market for bonds (when the price of bonds is going down), you can reinvest at higher rates. In a bull market (when the price of bonds is going up), you can take capital gains.

Purchase bonds that you can hold to their due date. If you buy short- and intermediate-term bonds, your market risk will be significantly reduced, since it is more likely that you can hold them until they come due. If there is inflation and interest rates go up, this is good news because when your bond comes due you can reinvest at a higher rate.

Buy individual bonds rather than bond funds. Remember that bond funds never come due. If interest rates go up and stay up for many years, which they have done in the past, you might have the equivalent of a permanent loss. In contrast, individual bonds come due at their face value. However, we do recommend bond funds for investing in junk bonds, TIPS, and mortgage securities.

Safe Investing Strategies

In bad times not only do interest rates often go down, but also the spread between the interest rates payable by solid issuers and weak issuers widens to reflect the higher chance of default of the weak issuers. The opposite happens in good times. The spread between solid issuers and weak issuers lessens, and you are not paid for the risk that you take by buying the weaker issues.

When spreads lessen across the rating spectrum, buy the good credits. Don’t reach for extra yield in good times when you are not being paid enough to take the risk. But, when spreads widen out between low- and high-grade credits, purchase lower-rated credits, if you feel safe in your judgment. If not, keep your assets in higher-rated bonds.

Buy pre-refunded munis. These are the safest financial instruments in the municipal bond area because they are backed by assets placed into an escrow account. Ask what the pre-refunded assets are, especially if the bonds have not been rerated.

Purchase Treasuries and agencies instead of corporates. You don’t need to diversify when you purchase Treasuries, so a Treasury fund is overkill unless you want the check-writing privileges. Some agency funds may contain leverage and derivatives and thus may not be as safe as you think. Pure GNMA funds are safe and worthy of your consideration.

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