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Understanding fixed income investments

by Steven Podnos Md, Cfp • Sept. 17, 2015 • 2 min read • original

Bear with me, as this topic is hard to make interesting. But, understanding these concepts when evaluating fixed income investments can make a great deal of difference in knowing the risks you take and the return you will get on your money.

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Remember that fixed income investments, in general, represent lending money to an entity (a corporation, a bank, a government) in exchange for a promise to pay back both the original money lent (principal) and something extra for your time and risk (interest). Here are four variables to consider that will affect your investments:

Time. Time is important, as most of the time (with inflation), a dollar in the future is worth less (will buy less) than a dollar today. So, if I give you a dollar today as a loan, I'd want you to give me back more than a dollar when the money is returned — in order to buy the same dollar amount of stuff, if not more.

Risk. Then, we need to consider the other risks of lending money — such as the risk of not being paid back some or all of the promised sums (principal and/or interest). A country may repudiate its debt (Russia and Argentina come to mind), a company may fail (GM, Enron, etc.), or an investment bank can fail (Lehman Brothers). There are currency risks also if you choose to lend outside your home country.

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Interest rates. But, today we'll focus on only the risk of interest rate changes. This risk is closely intertwined with that of time risk, as the effect of interest rate changes is magnified by longer periods of time. For example, you may lend $1,000 to the U.S. government by buying a Treasury bond. You have no real credit risk — as the U.S. government can always just print the dollars to pay you back. You have no currency risk, as you are investing in your own country. But you have time and interest rate risk. If the bond you purchase pays say a 3% interest rate and will redeem your original investment in one year, then if interest rates move up rapidly, you probably don't care. You'll have your money back in 12 months to reinvest at higher rates. But, if you lent the money for 3% for 10 years, a rise in interest rates will cause you to suffer financially. Most of the time, interest rates rise due to inflation.

Inflation. Let's imagine that you have purchased a 10-year U.S. Treasury bond that has 10 years to maturity. When purchased, it yields 2% interest a year. Now, inflation rises from some lower value to 3% a year after you buy your bond. If the value of your dollars is dropping at the rate of 3% (due to inflation), then after holding your bond for ten years, you have made no real gains (and a loss after taxes). You have also lost out on the opportunity to invest at higher rates during that time. If you tried to sell your bond early in its life when interest rates moved up, you'd lose about 9% of principal for every 1% that interest rates went up.

Conversely, holding longer maturities pays off when interest rates are stable or decreasing (as we experienced for the last 30 years). Given today's ultra-low rates, it seems a risky bet to own long-maturity bonds.

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