Learn to recognize the dangers and benefits of your investment choices

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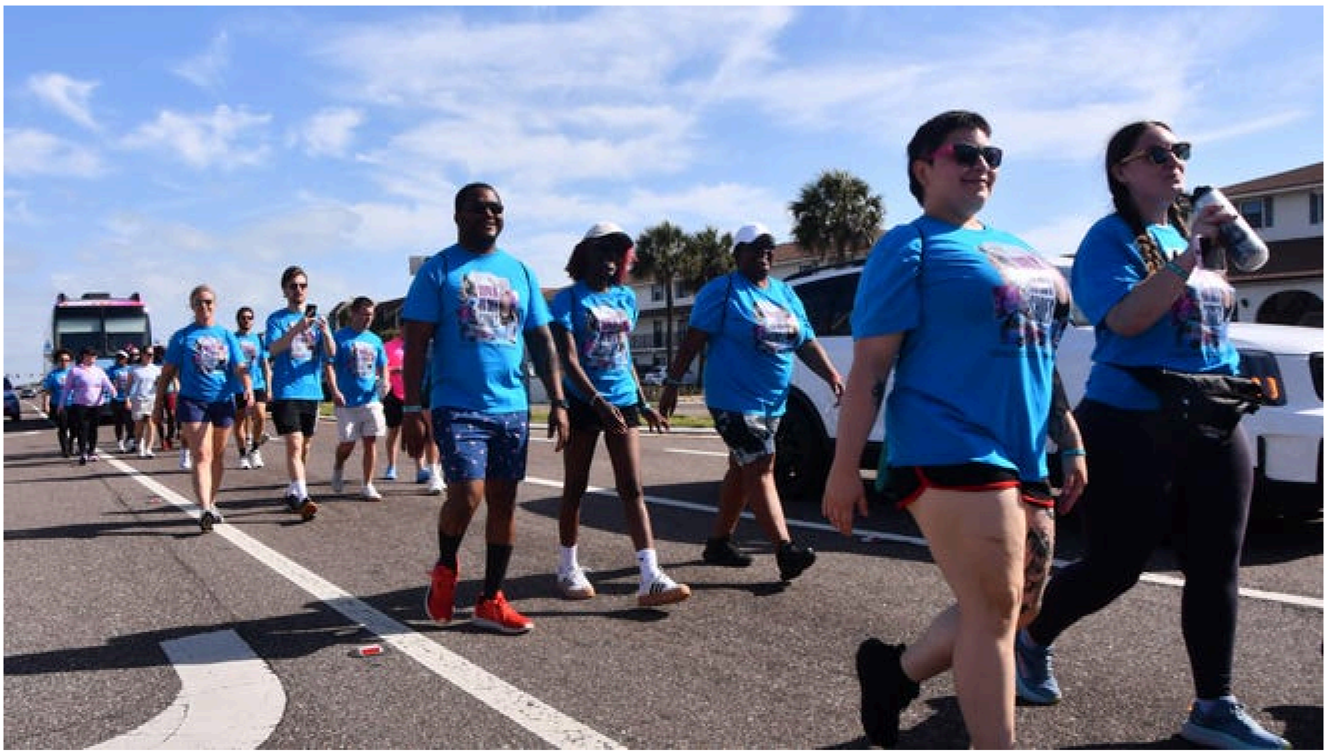
Q: I read that conservative investing means more bonds in my portfolio — but is this ever risky?

A: As a short answer, yes, bonds can be risky. Understanding this when considering fixed income investments can make a great deal of difference in knowing the dangers and benefits you may get with your investment choices.

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



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Time is important, as 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 with the dollars that I can buy today (if not more).

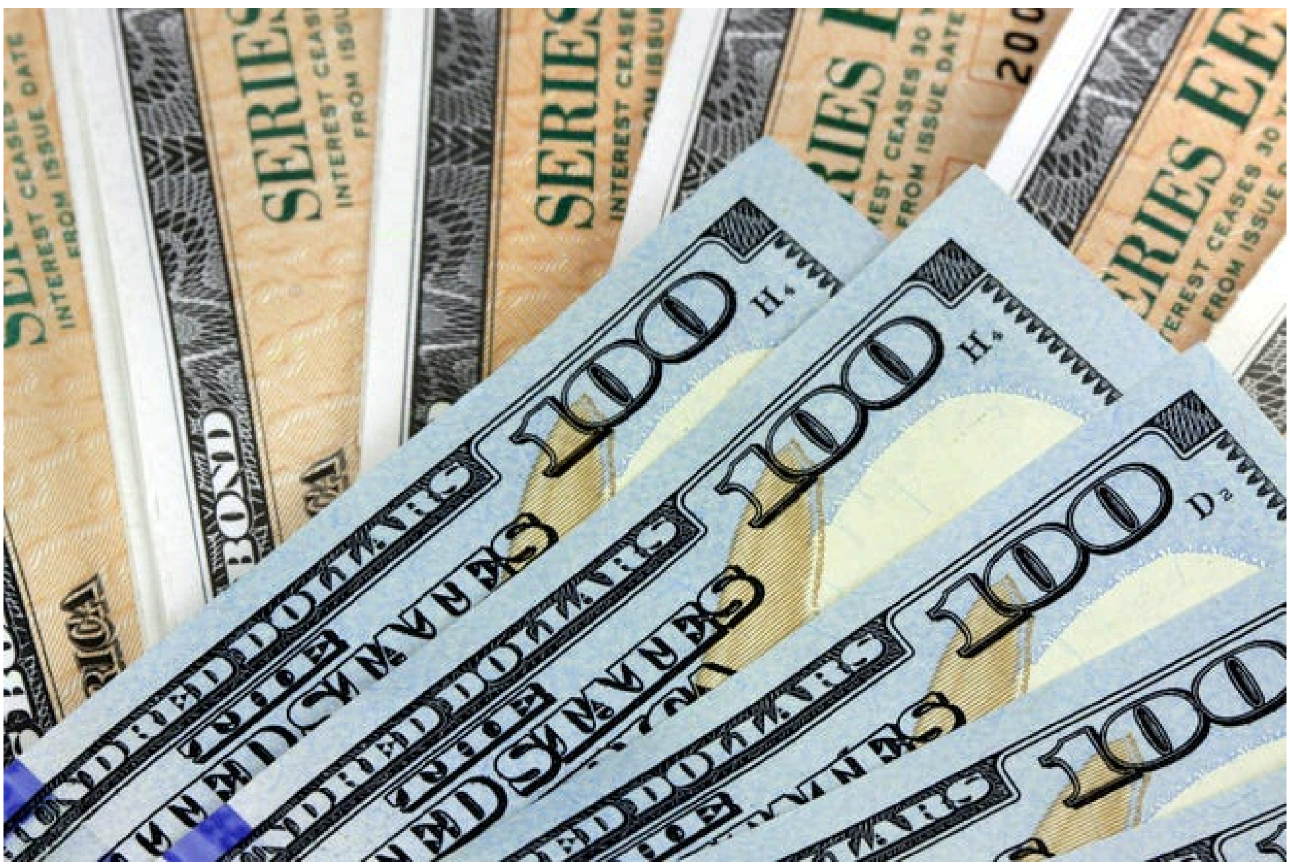
We also need to consider the other risks of lending money-such as the risk of not being paid back some or all the promised sums (principal and/or interest). A country may repudiate its debt (Russia and Argentina come to mind), a company may fail (GM, Enron etc.), or even an investment bank can fail (Lehman

Brothers). There are also currency risks (another country's money usually moves up and down in price compared to our dollar) if you choose to lend outside your home country.

The future of interest rates? Hard to predict

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. Consider a bond that you purchase which pays a 3% interest rate and will redeem your original investment in one year. If interest rates move up rapidly in that year, you probably won't care much. You'll have your money back in 12 months to reinvest at higher rates. But, if you lent the money at 3% for 10 years, a rise in interest rates will cause you to suffer financially. Some of the time, interest rates go up due to real or perceived future inflation. Investors who worry about a reduced future purchasing power of their dollars will usually demand higher interest rates to loan money over longer periods. The Federal Reserve might raise rates to slow down a "hot" economy even without clear cut inflation.



Let's imagine that you have purchased a 10-year U.S. Treasury bond.

When purchased, it yields 2% a year (as it did just five years ago). After a year goes by, new 10-year bonds are paying an interest rate of 3% (could be a result of Federal Reserve behavior and/or investor fear of future inflation). If the value of your dollars is dropping at the rate of 3% (inflation rate of the same), then after holding your bond for 10 years, you have lost purchasing power every year, magnified by the fact that you have to pay taxes on the interest. 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. In the last five years, interest rates have risen sharply, and most fixed income has produced losses — despite being the "conservative" part of a portfolio.

Conversely, holding longer maturities pays off when interest rates are decreasing, as happened between the early 1980s (for 30 years!). As the future of interest rates can be difficult to predict, one way to mitigate risk is to shorten the term at which you are lending to others.

So yes, bonds can be risky in many ways. No one ever said investing is easy.

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