Karen Telleen-Lawton: Why I Hate Bonds

They may fill a niche for some people, but their returns are lower and their sustainability is questionable

By Karen Telleen-Lawton, Noozhawk Columnist | Published on 12.27.2010 3:55 p.m.

I never thought I'd write a column about bonds. I know they serve a legitimate purpose from the standpoint of a business or government seeking funds. When entities want to raise money by borrowing rather than floating stock, they sell bonds. It's just that as an individual investor, I haven't felt like they were a sustainable part of my portfolio.

Karen Telleen-Lawton

Most asset allocation guides advocate 20 percent of one's investable funds to bonds, plus or minus percentage points depending on age or risk tolerance.

Mark Riddix, an investment adviser who writes a blog called Buy Like Buffet, believes that bonds belong in your portfolio at any age. He considers the advantages of bonds to be diversification, regular income, and sometimes risk and tax benefits.

Do these characteristics still hold? Let's take a look.

Income: Bonds typically pay a coupon every six months at a set rate. This is your payment for loaning money. As long as the issuing organization is solvent, bonds are a pretty dependable source of regular income. Statistically, bonds' maximum and average returns are lower than for stocks, but their minimum return is higher for periods less than 15 years. (For periods longer than 15 years, stocks perform better on all measures.)

Risk: High-quality bonds are worthwhile when your criteria are preservation of capital and safety. If you buy a new bond and hold it to maturity, you will get the amount promised (again assuming no default). Alternatively, you can buy existing bonds at a discount if interest rates have risen, or pay a premium for an existing bond bearing a higher-than-market interest rate. Thus, if you trade in bonds or buy a fund that holds bonds, you can make or lose money just as with stocks.

The highest quality bonds (U.S. government) are safer than the safest stocks. Moreover, corporate bonds are safer than the same company's stock, since debt holders (bondholders) must be paid before the owners (stockholders). But it's difficult to assess bonds' safety on an absolute level. Credit rating agencies such as Moody's, Standard and Poor'sand Fitch are notorious grade-inflators. Bonds rated as high as B-plus or B1 can be highly speculative.

Tax: Government-issued bonds pay a lower return commensurate with their tax breaks. Federal bonds are municipal tax-free, while municipal bonds are free of federal taxes. Some bonds are free of federal, state and local taxes. Typically, bondholders in a marginal tax bracket lower than 25 percent are better off with taxable bonds.

Diversification: According to Errold Moody, an analyst and registered investment adviser, "Going back 20-plus years ago, stocks and bonds were effectively negatively correlated. That's why most investors were told to use some of each. ... But as the inflation rate and the interest rates have dropped, the correlations between these two is now maybe 0.8. That's a pretty strong positive correlation." In the past couple of decades, the correlation between stocks and bonds has been called "moderately positive," such that bond prices move similarly to stocks.

So here's where I am. I still don't like bonds. Their returns are lower, often without commensurate reduction in risk or taxes, and they can no longer be counted on to be bullish when stocks are bearish.

Nevertheless, I believe they can fill a niche in an individual portfolio for retirees and those approaching retirement whose goal is capital preservation capital or income generate. But with interest rates still so low, I can’t help dawdling a little longer before moving from investing in a company to helping it pay its bills.

— Karen Telleen-Lawton’s column is a mélange of observations supporting sustainability. Graze her writing and excerpts from Canyon Voices: The Nature of Rattlesnake Canyon *at www.CanyonVoices.com*.