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WEALTH MANAGEMENT

Clearing Up Misperceptions on Bonds

Advisers should help clients understand role, value of fixed income in balanced investment portfolios

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Over my nearly 30 years in bond investing, I've learned the various misperceptions that investors have about how this asset class works. These misperceptions can lead clients to overreact to market trends and make rash or misguided financial decisions. To help clients see and avoid these pitfalls, advisers should take time to understand how investors' pre-existing notions about bonds can veer from reality.

One common error I encounter is people's idea that we have a unified bond market, not a market of bonds. When investors say "the bond market is unattractive," they fail to appreciate how at any given point some types of bonds are overvalued while other types are undervalued. Investors may be concerned by rising rates, but a rising-rate environment causes some bonds (such as high-yield and floating-rate debt) to do reasonably well. So there are plenty of colors on the palette, and a skilled adviser can help their client implement the best ones for each situation.

Calamos Investments' Matt Freund... Bonds are clients' best hedge on stocks, and in many cases bonds outperform when stocks underperform. PHOTO: CALAMOS INVESTMENTS

Another common misperception is that there will always be parallel changes in interest rates. If the Federal Reserve raises short-term interest rates, people might assume that will cause an equal increase for 10-year, 20-year, and 30-year bonds as well. The truth is different. Parallel rate changes are unicorns: They don't exist.

For clients who understand that bond prices fall as rates rise, the prospect of multiple Fed rate increases might make them fear their assets will decline in value. What they don't consider is that bonds will continue to mature at par, or face value, as long as there is no default.

Clients also tend to forget that bonds pay interest that can offset price declines. The final piece of the puzzle is that as the remaining time to maturity gets shorter, a bond's sensitivity to changes in interest rates diminishes. Together, these facts can minimize a bond's losses and in some instances provide a positive total return by "rolling down the yield curve" despite rising rates. In other words, if I buy a five-year bond today, what will it be a year from now? A four-year bond, naturally. That means I will have earned a year's worth of interest and will be a year closer to maturity. Many people don't understand that the combination of these factors can leave them in a more stable position than they think.

Advisers can help clients avoid these and other frequent mistakes by reminding them why they are investing in bonds in the first place. Bonds are clients' best hedge on stocks, and in many cases bonds outperform when stocks underperform. Combine that diversification advantage with the general value of an inflation-beating, safe income-producing asset, and there will always be a place for bonds in a properly balanced portfolio. By shedding light on these core ideas and correcting misperceptions, you can help your clients steer clear of mistakes so they get the most out of their fixed-income investments.

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