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Above The Canopy is dedicated to helping you make consistently smart financial decisions. Our content covers many of the important aspects of financial planning and investment management you'll face over the years.

We love to work with:

- Entrepreneurial people & families. This mostly includes business owners & executives, physicians, and attorneys
- Small to mid sized businesses. We help build and manage 401(k), 403(b), profit sharing, and other retirement plans.
- People of all ages, ranging from couples navigating toward retirement, to graduates starting their careers, to retirees looking to preserve and distribute their assets efficiently.
- People seeking to reduce stress when it comes to financial decision making.
- People seeking to simplify their life by organizing and optimizing their finances.

If you're new to Above the Canopy, explore any of the blog posts or articles on our site for free. You'll find content on financial planning, investment research, economic issues, entrepreneurship, and business management.

We love our community & readers as well. If you have special questions or issues you'd like us to answer, feel free to reach out. We're happy to point you in the right direction.

7 Ways to Lose Money With Bonds

For the last few decades, bonds have been perceived as a very low-risk asset that can be used to diversify and reduce risk in stock heavy portfolios.

Moreover, bonds have remained popular over the years because they are able to create steady streams of cash flow.

And although investors across the country have certainly lost money in bonds here and there over the years, today’s “Perfect Storm” interest rate environment is setting up what could possibly be the biggest bond bubble in history.

The average investor has absolutely no clue about the risks involved in holding bonds, or how a spike in interest rates could affect their bond holdings.

It's important to understand what's in your portfolio (even if you don't manage it yourself).

So to help explain how bonds work, and convey some of the risks involved in holding them, I put together this guide.

Let’s jump right in.

1: Lack of Liquidity

Do you recall a few years back when Detroit made headlines when it went bankrupt?

Here was a city that at many times over the years was one of the most vibrant & flourishing in the country.

And a short time later it was going bankrupt.

Investors holding Detroit bonds were in trouble.

Try as they did to sell their positions and get *something* in return, most couldn't, and lost their entire investment.

Yet, thirty years ago few people in America would have ever bet that bonds issued by the city of Detroit would be so difficult to liquidate, let alone default.

And Detroit is just one example.

While the bond market is larger than the stock market in total *value*, the bond market is also far less *liquid*.

Compared to the number of stock traders & investors, there is just a fraction of the number of bond traders and investors participating in the capital markets.

And pursuant to regulations passed after the mortgage crisis, brokerage houses hold fewer bonds in their inventory than they once did.

During times of financial crisis (or any time a city, state, municipality, etc. whispers "default"), bond investors often have difficulty finding buyers in the market.

If you aren't one of the first to know about it, chances are good you'll be stuck waiting out the storm (and possibly lose some or all of your investment).

In general, a good rule of thumb when it comes to bond liquidity is the smaller the issuer of the bond, the greater the liquidity risk in holding it.

Choose wisely.

2: Interest Rate Fluctuations

Bond interest rate fluctuations are probably the most widely known risk to bond investors.

If you aren't familiar with this idea, just remember that bond prices are **inversely** related to interest rates.

That means that when interest rates go up, bond prices go down.

And vice versa.

So when we are sitting close to all-time low interest rates with really nowhere to go but up (as we are now), you can begin to understand why this fear is discussed so much in the press.

When interest rates do finally go up (and they will), this could do serious damage to bond prices AND the bond market in general.

As interest rates begin to creep up, many investors will be shocked that their supposedly "safe" investment has just lost value.

If interest rates rise quickly, this could easily cause bond investors to run for the door en masse, causing widespread panic.

Here's an example of what happens when interest rates go up:

If you buy a bond for $1,000 that pays you 4% in interest every single year, what would happen if the market interest rate for the same bond rose to 5%?

All of a sudden, your bond wouldn't look so good.

Another investor has the choice between the new interest rate of 5%, and your bond paying 4%.

Which do you think they'd choose?

The market value of your bond would fall, exemplifying interest rate risk.

The most important thing for bond owners to understand when it comes to interest rate risk is **duration**.

Duration is a metric used to measure how the price of bonds fluctuate when interest rates change.

A bond's duration is created by taking into consideration its maturity, yield, coupon, and call features.

The higher a bond's duration, the more sensitive it is to interest rate adjustments.

For example, a bond with a one-year duration only loses 1% of its value if interest rates rise 1%.

A bond with a ten-year duration loses 10% if interest rates rise 1%.

Even though it might be tough to envision today, we will see interest rates drastically higher than they are today.

3: Bond Creditworthiness

When most people think about the creditworthiness & risk of a bond they hold, they only consider bankruptcy.

However, it doesn't just take a bankruptcy to crush or eliminate bond prices.

But before we get into that, let's cover risk and reward with regard to bond creditworthiness.

To begin, the yield (your return) on any bond investment correlates with the overall creditworthiness of the entity issuing the bond.

This is the simple risk/return spectrum that we're all familiar with.

For example, you will get the smallest yield (return) on the safest and strongest issuers, such as the Unites States of America.

On the other hand, you can get yields hundreds of times higher if you're willing to invest in low-grade junk bonds or very high-yield corporate bonds.

However, when you do so you're taking on significantly more risk, since junk & high-yield bonds are more likely to default.

Now, a default occurs when the bond issuer is no longer able to make interest or principal payments to you.

This could happen during a bankruptcy as mentioned above, but it can also occur if a credit rating agency downgrades the issuer.

Huge price declines can also occur (almost overnight) if one of the credit agencies decides to place the bond issuer on "credit watch" status, which would normally happen well before bankruptcy talks even happen.

The takeaway here is to know your risk tolerance & a potential investment's creditworthiness before you invest.

4: Inflation / Hyperinflation

Generally speaking, inflation is usually followed by higher interest rates.

And as we covered earlier, interest rates and bond prices are inversely related.

Thus, higher inflation usually causes bond prices to fall.

But inflation has another dagger to throw at bonds.....negative purchasing power.

When we experience inflation in the economy, the prices of things we buy & consume rise.

So, if you have a bond paying you 4% for the next few years and inflation rises to 8%, you are actually earning ***negative 4%*** in terms of your purchasing power.

There is a type of bond that protects you against inflation: Treasury Inflation Protected Securities (TIPS).

These are usually short-term bonds, whose coupon interest will adjust depending on the rate of inflation throughout the economy.

These types of bonds can be very interest rate sensitive though, so if we never experience inflation (or even worse, have deflation) they can actually hurt you, thanks to their ultra-low yields.

5: Reinvestment Risk

The economy and the stock market have been growing very consistently since 2009.

And although we'd like to think that everything will continue moving up forever, history tells us that it assuredly won't.

In fact, 100% of every 5-year or longer bull market run has resulted in at least a 10% correction at some point.

So once again, it is not a matter of *if* the economy slows down at some point, it is a matter of when.

One of the consequences of a slowing economy is that interest rates can slow down as well.

And when interest rates decline, bond investors are forced to reinvest their interest payments (and any return of principal) into new securities that have lower rates of return.

This works to reduce the overall income that's generated by your bond portfolio.

The good news is that zero-coupon bonds do not have this reinvestment risk because you aren't collecting payments throughout the term.

The big takeaway here is that reinvestment risk is greatest for bonds with higher coupon or interest payments.

And of course, this risk is only pertinent if interest rates go **down**, which is the opposite of most other bond risks.

6: Bond Fund Backfire

Another popular way to invest in bonds is through bond **funds**.

In many cases this is a great way to spread out risk, when compared to buying individual bonds.

Bond mutual funds still contain many of the same risks as individual bonds, though.

But because the bond fund contains numerous individual bonds that are all expiring and held for different *time periods* (and purposes), these risks are usually pretty well spread out.

This same idea of having staggering expirations (or maturities) in a fund can present some compounding problems down the road, though.

Here's why.

In a rising interest rate environment, as the bond fund manager replaces bonds as they mature the net asset value (NAV) and return on the bond fund fall as well.

It might seem bad enough that the entire bond fund portfolio will lose value.

But the real pain comes if investors decide to leave the fund and sell - during market panic, for example.

When this happens, the bond manager is forced to sell some of the bond holdings to meet redemptions, which further harms the value of your fund - especially if the manager is forced to sell some of the highest yielding bonds first (and then must replace them later with lower yielding bonds).

The takeaway here is to always stay up to date and educated on what is going on with bond funds you own.

You do not want to be the last one to find out a big shift or sell-off.

7: Making Bad Bond Assumptions

Our final risk is more or less a summary of the other risks we've covered:

Don't ever make the assumption that your bond or bond fund is free from risk and/or completely stable.

When you hear about people losing some, most, or even all of their money in bonds, it is rarely the bond trader on Wall Street causing the damage.

Instead, it's the average trader with a day job that made the false assumption their bond investments were safe and never needed to be reviewed.

By staying educated and up to date on the markets, economy, and your own holdings, you can avoid this situation.

And as always, if you have any questions related to your bond portfolio or financial situation, feel free to reach out to me directly.

Unanswered Questions?

It's my sincere intent to provide valuable, premium content in the guides I publish. However, I realize that sometimes I may raise more questions than I actually answer.

If this is you, feel free to reach out to me directly with any questions or issues you may have. I'm happy to point you in the right direction.

Best Regards,
Grant Bledsoe, CFP®, CFA

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