Bond Risks

Two major risks attach to bond values: quality risk and duration. They are worth reviewing in this rather precarious market for bonds in investment portfolios.

Quality Risk

The two best known rating agencies continue to be Moody's and Standard and Poor's, although their reputations were sullied in the financial crisis several years ago. They both missed credit deterioration of financial companies dealing with mortgage type bonds, Countrywide Credit and Nationsbank for example. Rating agencies have sometimes been accused of bias in "shopping" for the ratings of firms.

More recently a new agency, Egan-Jones, was established in 1995. As explained, "Sean Egan, principal of Egan-Jones appeared before Congress on October 22, 2008 and argued that issuers of complex securities 'shopped' for ratings which resulted in a race to the bottom in terms of credit transparency."

Certainly investors in bonds should trust, but closely verify, ratings of firms that may be conflicted regarding their findings.

Another credit issue involves credit changes by the agencies. Beware of bonds that have recently been cited as "credit watch negative." Take a look at two recent five-year bond offerings as follows: the first one carries a high quality rating by Moody's of Aa3 and is priced to yield 2.078% while a second one carries a barely investment grade Baa3 rating and consequently yields 3.019%. An investor looking at these two issues sees that the Baa3 bond is less valuable, but is much riskier in that any financial deterioration in the company could result in a credit rating drop below investment grade, or something less than Baa3, to "junk status." Hence the latter bond becomes much less valuable.

Interest Rate Risk: Duration

An even more potent bond risk can be found in the rate of interest investors demand at any given point in time. Ibbotson Associates a well respected economic firm, has calculated the rate on short term Treasury Bills to be 3.6% annually since 1926. Now however these rates have fluctuated at historic lows. Ninety Day T. Bills today yield a fraction of 1.0%, in part as a result of the Fed and its accommodating monetary policies.

Many in the investment field have wondered when rates will trend upward, as history shows they will. When they do, bond values will decline. Duration is the mathematical calculation of a bond's interest rate sensitivity. Duration takes into account not only the return of principal at its maturity, but also factors in the semiannual coupon payments. Shorter term bonds with full coupons provide a cushion for investors as market rates rise. Conversely longer bonds with longer duration suffer greater during these periods. A bond with a five year duration will lose five percent of its value, when market rates rise one percent.

As an example note that Toyota has a bond with a maturity date of 2020, at which time the full face value will be repaid. However, the bond carries a 4.5 % annual coupon rate, payable on a semi-annual basis. Thus this bond's duration calculates at 5.0 rather than it's maturity which is six years.

Some economists wonder when the Fed will relent on Quantative Easing, so that rates can rise. But the U.S. economy is still weak meaning that rate tightening may not occur until mid 2015 or later.

The Bond Investment

Credit risk and duration play an important role in the purchase and holding of bonds. The goal of bonds in a portfolio, other than producing income, is to dampen volatility. For now and the foreseeable future, bonds of high credit worthiness and short duration are the order of the day.