Four Potential Alternatives
to the Bond Market

***Be informed,** not influenced.*

Since the Great Recession of 2008/2009, I've written many articles about the bond market. My book, published in 2019, *The Informed Retiree*, dedicated a whole chapter to the subject. In fact, a good portion of the book revolves around the topic of interest rates. Why? Due to the simple fact that a retiree's financial life involves interest rates and how they influence so many facets of one's financial life in retirement.

Many questions surround this topic: Will I have enough "total return" from my investments to be able to live comfortably for 30 or 40 years? Could I suffer losses in the portion of my portfolio that is invested in bonds if interest rates rise? How much can I withdraw from my investments? Most experts state 4%, but with interest rates so low, is that still feasible?

The questions involving interest rates are plentiful, and currently, the Federal Reserve is keeping rates at emergency levels. Just prior to the Great Recession, the 10-year Treasury bond, the benchmark for bonds, was approximately 5%[1]. During the midst of the Covid19 stock market scare, levels for the 10-year Treasury fell below 1%[2] for the first time in its history.

It's vital that you understand the relationship between the price of a bond and interest rates. Putting it simply, when interest rates fall, the price of the bond appreciates in value. Interest rates have gradually fallen since the early 1980s, when rates were over 15%. See the 10-year Treasury chart below.

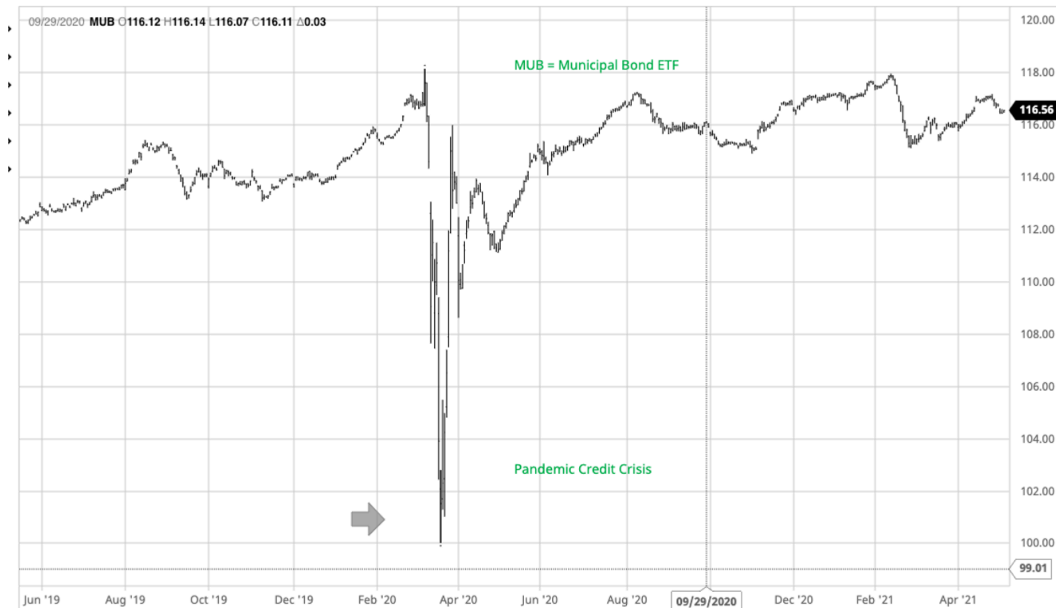
Fast forward to today, the price of the bond has risen dramatically due to the fact that interest rates have fallen dramatically. My point? We are now back to the simple math issue and the questions surrounding the value of bonds. How much further can interest rates fall? If the floor is 0%, there isn't near as much runway as there was back during the Great Recession when interest rates were around 5%.

All this math, rising and falling rates, presents a few important questions. After fees and inflation, if interest rates stay low, will the portion of my portfolio invested in bonds generate a return to support my withdrawals? What if, instead, interest rates rise? How will potential losses affect the total return of my portfolio? Are there alternatives to the bond market?

Keep in mind another potential issue that comes with investing in bonds. If you were to ask your family, friends, or anyone on the street the following question, "Are bonds safe," what do you suppose they would say? The overwhelming response would be likely a resounding, "Yes, they are safe. Or at least they are safer than my stock portfolio." If you were to invest 100% of your bond portfolio in the United States Treasury bond, then yes you could likely agree with that statement. However, most portfolios designed by financial advisors do not contain this type of bond. The majority would be invested in credit-sensitive bonds, the type of bonds that are backed by the full faith and credit of the company that issues the debt. There have been several instances over the past 15 years where the bond market has been in dire straits for a period until the Federal Reserve came in to bail it out. The most recent was during the spring of 2020.

Personally, I witnessed credit-sensitive bonds, such as investment grade, rated A or better, drop 25%-30% within weeks.[3] See picture to the left; municipal bond mutual funds falling 5%-10% in a single day.[4] See the picture below.

This example is extreme, but the point is to help investors comprehend the bond market may not be as safe as some may assume. This is one of those ideologies that becomes engrained in people and is passed on for generations. The bond market, especially with interest rates below the rate of inflation, may not be the best place to invest a large portion of your nest egg and may not be quite as safe as you may believe.



Most investors don't purchase individual bonds, but rather, bond mutual funds is the typical choice. This is good for diversification, as the mutual funds purchase generally hundreds of individual companies, but there is a hidden flaw with bond mutual funds. There is no maturity date with a mutual fund. Hence, while the bonds inside the fund mature depending on the duration of the bond, due to the structure of the mutual fund, it's a perpetual offering that has no maturity date. Thus, for example, if interest rates begin to rise over the coming years, while an individual bond may mature, the bond mutual funds will continue to purchase new bonds and those bonds, too, may suffer potential loss of value. This is due to the simple math issue we've discussed. As rates rise, the price of the bond falls, and thus the mutual fund suffers along and the cycle continues. A question for all investors is: What if rates begin to shift - the pendulum swings, so to speak - and the four-decade-long decline in interest rates start to shift the other direction? Imagine if interest rates begin to rise over time, causing bond funds to lose value. This would be a major change for investors.

The vast array of financial advisors that you see on every corner of Main Street invest using the broad diversification approach, Modern Portfolio Theory.[5] As you get closer to retirement, it's generally recommended to reduce your stock allocation and increase your bond allocation. Now think about what you just read in the information above.

Do you see flaws with that logic? Don't get me wrong, if you're shown the total return performance of a 50% stock and 50% bond moderate portfolio going back 40 years, it would've likely achieved the goal of providing a comfortable retirement. But, again, it begs the question of simple math. That same portfolio today with interest rates at record lows will have a difficult job providing the safety cushion, interest payments, price appreciation, nor the overall total return investors have become accustomed to since the 1980s. I just need to say, there has to be a better alternative!

With all that stated, where can investors look to achieve a similar objective with bonds? Are there some alternatives? This is addressed in my book in greater detail. This can be downloaded for free at www.TheInformedRetiree.com, or can be purchased on Amazon.

Below is a list of four alternatives to buying a bond mutual fund. In my opinion, there is only one of the four that is beneficial for a long-term retiree, due to where interest rates are currently, among other risks. It's entirely possible that interest rates over the next several years could climb back to levels where it makes sense to invest in bonds. However, until a significant increase is achieved, a retiree should consider these and other potential alternatives. I'm not going to state every pro and con for these alternatives, just a high-level overview of instruments to consider that may achieve a desired result.

Certificate of Deposit/Fixed Annuity. Issued by banks and insurance companies, these have a significant level of protection and provide consistent interest without fees. Of course, it's difficult to get a CD that provides a decent rate these days, at least until the Federal Reserve hikes rates. Fixed annuities provide generally a higher rate than CD's, but come with other considerations such as credit ratings and surrender periods.

Individual Bonds. The benefit of buying individual bonds is there is a maturity date unlike bond mutual funds. Thus, if you purchase a company bond such as General Motors, you have to consider the ability for the company to repay your investment. The purchase of individual bonds has faded over the previous 20-30 years. Most retirement plans such as a 401k do not offer individual bonds, but rather, mutual funds. Most financial advisors also use mutual funds over individual bonds for diversification purposes. Building a diversified portfolio of individual bonds has its challenges, liquidity risks, and costs, so it's not common practice within the financial industry.

Floating Rate Bond Mutual Funds. There are many types of bonds. Treasury bonds, as we've discussed, are sensitive to prevailing interest rate movements. Bonds that are issued by individual companies are corporate bonds and are interest-rate sensitive, but also credit sensitive. There are other types of bonds, too, such as mortgage bonds, among others.

Corporate bonds can fluctuate in value due to many factors. Liquidity can be a factor, and during times of credit stress, there can be a lot of volatility. If credit is favorable, growing GDP and good liquidity, then bonds that adjust with rising interest rates can be an alternative. Floating rate bonds, also known as bank loans, under favorable environments, can be an alternative, as they are less likely to be affected by rising rates, and they tend to pay a higher rate of interest. However, these bonds can experience high volatility if certain conditions are met, such as the credit crisis we witnessed during the Great Recession and the Covid19 Pandemic.[6] See chart to the left. While floating rate bonds are a potential alternative, it does not come without risks and need to be heavily monitored.

The final alternative, we will refer to as a "bond surrogate." The official name I'm going to keep a secret for now. The characteristics of this potential solution, in my opinion, is well worth consideration as a surrogate for bonds, especially bond mutual funds. There is a whitepaper written by Roger Ibbotson[7] that compares investing in bonds to investing in the vehicle I will highlight below. I would recommend searching for that article. What are some of the highlights of this potential candidate?

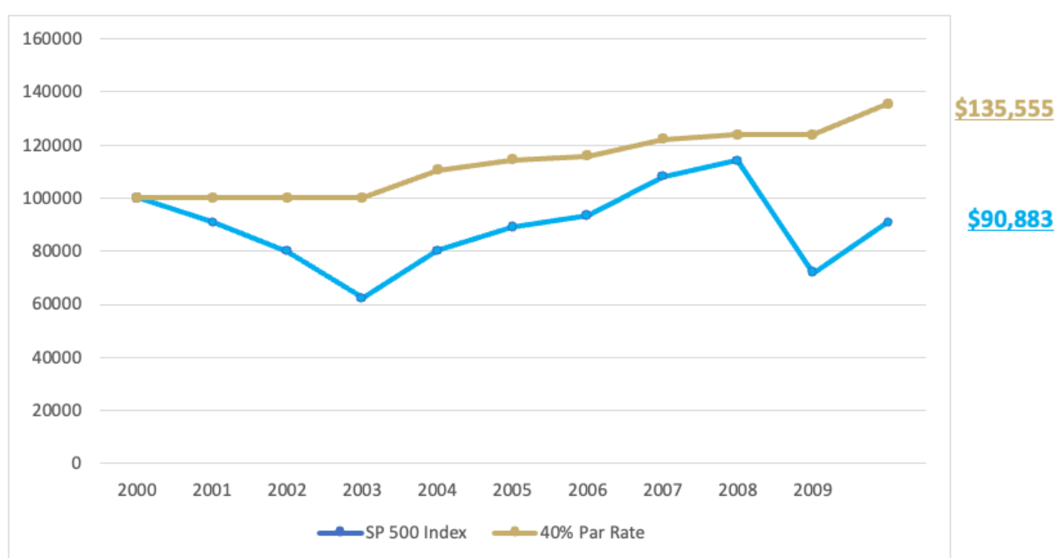
Items of Interest:

a. **Initial deposit is principal protected from financial market losses.**

b. **Interest increases based on index offered are credited on anniversary.**

c. **Lifetime income options are available. Pay income for the life of the owner and spouse, if elected.**

There are many companies that offer this type of investment, but you must be able to understand which one meets your needs specifically. There is no "one shoe fits all," and they come with varying options. It's important to diversify like any other investment out there to reduce risks. Item "a" highlights the principal guarantee of the vehicle, but keep in mind, there is no guarantee of interest gains. Yet if you understand the value of the index-crediting option, then you'll see even in years such as 2000-2009, under the right circumstances, there could be index interest earned.[8] See chart below. There are also many types of index-crediting options out there, as highlighted in item "b." These can credit annually, biennial, or even triennial, and as usual, diversification is key. Item "c" highlights a benefit that is like no other in the financial industry, guaranteed lifetime income.



SP 500 Including Dividends - https://www.slickcharts.com/sp500/returns
SP 500 Index Participation Rate = 40% - Does not include dividends.
https://www.thestreet.com/investing/annual-sp-500-returns-in-history

What does this feature, guaranteed lifetime income, mean for the investor? Consider this example: If you invested money in a CD, earned 1% interest and withdrew 4% each year for income, you would run out of money in about 29 years. Would you then go to the bank and ask why your income was no longer being deposited? Of course not! You ran out of money. However, with the lifetime income benefit, even if you exhaust your account, the company is still obligated to continue your income. There is not an investment that exists other than Social Security or a pension that has an equivalent benefit.

I stated earlier that this paper would be kept short. Wrapping this up, I wanted to provide an overview that helps investors see the need to consider alternatives to traditional bond funds.

To reiterate, it's simply a math problem, it's nothing personal. If interest rates were much higher, then we wouldn't be sounding the alarm.

What should you do now? My first suggestion is to understand the problem.

Then, if you appreciate being made aware of a potential problem, schedule a **"strategy session"** so we can work together to address it.

In addition, I encourage you to read my book, as it goes into more detail on bonds and the bond surrogate I touched very briefly on above. If you're working with an advisor that does not have options available, which is common, then it makes sense to get a second opinion.

The good news is there are solutions!

Be informed, not influenced.

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Access my Calendar Here: https://calendly.com/len-13

You can purchase my book, *The Informed Retiree*, HERE

Disclosures:

1. https://www.macrotrends.net/2016/10-year-treasury-bond-rate-yield-chart
2. https://www.macrotrends.net/2016/10-year-treasury-bond-rate-yield-chart
3. https://yhoo.it/3o2hjRA
4. https://yhoo.it/3ewa6pM
5. https://www.investopedia.com/terms/m/modernportfoliotheory.asp
6. https://yhoo.it/2RDMW8a
7. https://som.yale.edu/faculty/roger-g-ibbotson

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