

## 16.3: Bond Strategies

### Learning Objectives

1. Discuss diversification as a strategic use of bonds.
2. Summarize strategies to achieve bond diversification.
3. Define and compare matching strategies.
4. Explain life cycle investing and bond strategy.

Bonds provide more secure income for an investment portfolio, while stocks provide more growth potential. When you include bonds in your portfolio, you do so to have more income and less risk than you would have with just stocks. Bonds also diversify the portfolio. Because debt is so fundamentally different from equity, debt markets and equity markets respond differently to changing economic conditions.

### Diversification Strategies

If your main strategic goal of including bonds is diversification, you can choose an active or passive bond selection strategy. As with equities, an active strategy requires individual bond selection, while a passive strategy involves the use of indexing, or investing through a broadly diversified bond index fund or mutual fund in which bonds have already been selected.

The advantage of the passive strategy is its greater diversification and relatively low cost. The advantage of an active strategy is the chance to create gains by finding and taking advantage of market mispricings. An active strategy is difficult for individual investors in bonds, however, because the bond market is less transparent and less liquid than the stock market.

If your main strategic goal of including bonds is to lower the risk of your portfolio, you should keep in mind that bond risk varies. U.S. Treasuries have the least default risk, while U.S. and foreign corporate bonds have the most. Bond ratings can help you to compare default risks.

Another way to look at the effect of default risk on bond prices is to look at spreads. A **spread** is the difference between one rate and another. With bonds, the spread generally refers to the difference between one yield to maturity and another. Spreads are measured and quoted in basis points. A **basis point** is one one-hundredth of one percent, or 0.0001 or 0.01 percent.

The most commonly quoted spread is the difference between the yield to maturity for a Treasury bond and a corporate bond with the same term to maturity. Treasury bonds are considered to have no default risk because it is unlikely that the U.S. government will default. Treasuries are exposed to reinvestment, interest rate, and inflation risks, however.

Corporate bonds are exposed to all four types of risk. So the difference between a twenty-year corporate bond and a twenty-year Treasury bond is the difference between a bond with and without default risk. The difference between their yields—the spread—is the additional yield for the investor for taking on default risk. The riskier the corporate bond is, the greater the spread will be.

Spreads generally fluctuate with market trends and with confidence in the economy or expectations of economic cycles. When spreads narrow, the yields on corporate bonds are closer to the yields on Treasuries, indicating that there is less concern with default risk. When spreads widen—as they did in the summer and fall of 2008, when the debt markets seemed suddenly very risky—corporate bondholders worry more about default risk.

As the spread widens, corporate yields rise and/or Treasury yields fall. This means that corporate bond prices (market values) are falling and/or Treasury bond values are rising. This is sometimes referred to as the “flight to quality.” In uncertain times, investors would rather invest in Treasuries than corporate bonds, because of the increased default risk of corporate bonds. As a result, Treasury prices rise (and yields fall) and corporate prices fall (and yields rise).

Longer-term bonds are more exposed to reinvestment, interest rate, and inflation risk than shorter-term bonds. If you are using bonds to achieve diversification, you want to be sure to be diversified among bond maturities. For example, you would want to have some bonds that are short-term (less than one year until maturity), intermediate-term (two to ten years until maturity), and long-term (more than ten years until maturity) in addition to diversifying on the basis of industries and company and perhaps even countries.

## Matching Strategies

**Matching strategies** are used to create a bond portfolio that will finance specific funding needs, such as education, a down payment on a second home, or retirement. If the timing and cash flow amounts of these needs can be predicted, then a matching strategy can be used to support them. This strategy involves matching a “liability” (to yourself, because you “owe” yourself the chance to reach that goal) with an asset, a bond investment. The two most commonly used matching strategies are immunization and cash flow matching.

**Immunization** is designing a bond portfolio that will achieve a certain rate of return over a specific period of time, based on the idea of balancing interest rate risk and reinvestment risk.

Recall that as interest rates rise, bond values decrease, but reinvested income from bond coupons earns more. As interest rates fall, bond values increase, but reinvested income from bond coupons decreases. Immunization is the idea of choosing a portfolio of bonds such that the exposure to interest rate risk is exactly offset by the exposure to reinvestment risk for a certain period of time, thus guaranteeing a minimum return over that period. John L. Maginn, Donald L. Tuttle, Jerald E. Pinto, and Dennis W. McLeavey, eds., *Managing Investment Portfolios: A Dynamic Process*, 3rd ed. (Charlottesville, VA: CFA Institute, 2007).

In other words, the interest rate risk and the reinvestment risk cancel each other out, and the investor is left with a guaranteed return. You would use this kind of strategy when you had a liquidity need with a deadline, for example, to fund a child’s higher education.

**Cash flow matching**, also called a dedication strategy, is an alternative to immunization. It involves choosing bonds that match your anticipated cash flow needs by having maturities that coincide with the timing of those needs. For example, if you will need \$50,000 for travel in twenty years, you could buy bonds with a face value of \$50,000 and a maturity of twenty years. If you hold the bonds to maturity, their face value provides the amount of cash flow you need, and you don’t have to worry about interest rate or reinvestment risk. You can plan on having \$50,000 in twenty years, barring any default.

If you had the \$50,000 now, you could just stuff it under your mattress or save it in a savings account. But buying a bond has two advantages: (1) you may be able to buy the bond for less than \$50,000 now, requiring less upfront investment and (2) over the next twenty years, the bond will also pay coupons at a higher rate than you could earn with a savings account or under your mattress.

If you will need different cash flows at different times, you can use cash flow matching for each one. When cash flow matching is used to create a steady stream of regular cash flows, it is called **bond laddering**. You invest in bonds of different maturities, such that you would have one bond maturing and providing cash flow in each period (like the CD laddering discussed in Chapter 7).

Strategies such as immunization and cash flow matching are designed to manage interest rate and reinvestment risk to minimize their effects on your portfolio’s goals. Since you are pursuing an active strategy by selecting individual bonds, you must also consider transaction costs and the tax consequences of your gain (or loss) at maturity and their effects on your target cash flows.

## Life Cycle Investing

Bonds most commonly are used to reduce portfolio risk. Typically, as your risk tolerance decreases with age, you will include more bonds in your portfolio, shifting its weight from stocks—with more growth potential—to bonds, with more income and less risk. This change in the weighting of portfolio assets usually begins as you get closer to retirement.

For years, the conventional wisdom was that you should have the same percentage of your portfolio invested in bonds as your age, so that when you are thirty, you have 30 percent of your portfolio in bonds; when you are fifty, you have 50 percent of your portfolio in bonds, and so on. That wisdom is being questioned now, however, because while bonds are lower risk, they also lower growth potential. Today, since more people can expect to live much longer past retirement age, they run a real risk of outliving their funds if they invest as conservatively as the conventional wisdom suggests.

It is still true nevertheless that for most people, risk tolerance changes with age, and your investment in bonds should reflect that change.

### KEY TAKEAWAYS

- One strategic use of bonds in a portfolio is to increase diversification.
- Diversification can be achieved
  - by an active strategy, using individual bond selection; or
  - by a passive strategy, using indexing.

- Spreads indicate the “price” or the yield on default risk.
- Matching strategies to minimize interest rate and reinvestment risks can include
  - immunization,
  - cash flow matching,
  - bond laddering.
- Life cycle investing considers the relationship of age and risk tolerance to the strategic use of bonds in a portfolio.

## Exercises

1. In My Notes or your personal finance journal, record your bond strategy. What will be your purpose in including bonds in your portfolio? What types of bonds will you include and why? Will you take an active or passive approach and why? How will spreads inform your investment decisions? Which bond strategies described in this section will you plan to use and why? How will your bond strategies reflect your needs to diversify, reduce risk, and maximize liquidity at the right times? How will your bond strategies reflect your age and risk tolerance?
2. View the video “Investment Bond Basics” at <http://www.videojug.com/interview/investment-bond-basics>. Discuss with classmates how this video serves as a review of the information in this chapter. As part of your review, brainstorm additional questions about bond investing to ask the expert.

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