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Chapter **1**

Focusing on Bond Fundamentals

Long before I ever knew what a bond was, I agreed to lend \$5 to Tommy Potts, a blond, goofy-looking kid in my seventh-grade class. This was the first time I'd ever lent money to anyone. I can't recall why Tommy needed the \$5, but he did promise to repay me, and he was my pal.

Weeks went by, then months, and I couldn't get my money back from Tommy, no matter how much I bellyached. Finally, I decided to go to a higher authority, also known as Tommy's dad. I figured that Mr. Potts would give Tommy a stern lecture on the importance of maintaining his credit and good name. Then Mr. Potts would either make Tommy cough up my money, or he'd make restitution himself.

“Er, Mr. Potts,” I said, “I lent Tommy five bucks, and —”

“You lent *him* money?” Mr. Potts interrupted, pointing his finger at his deadbeat 12-year-old son, who, if I recall correctly, at that point had turned over one of his pet turtles and was spinning it like a top.

“Um, yes, Mr. Potts — \$5.”

Mr. Potts neither lectured nor reached for his wallet. Instead, he erupted into boisterous laughter. “You lent *him* money!” he bel-lowed repeatedly, laughing, slapping his thighs, and pointing to his turtle-spinning son. “You lent *him* money! *Ha . . . ha . . . ha . . .*”

And that, dear reader, was my very first experience as a creditor. I never saw a nickel from Tommy, in either interest or returned principal. Oh, yes, I’ve learned a lot since then.

Understanding What Makes a Bond a Bond

Now suppose that Tommy Potts, instead of being a goofy kid in the seventh grade, were the U.S. government. Or the city of Philadelphia. Or Procter & Gamble. Tommy, in his powerful new incarnation, needs to raise not \$5 but \$50 million. So, Tommy decides to issue a bond. A bond is really not much more than an IOU with a serial number. People in suits, to sound impressive, sometimes call bonds *debt securities* or *fixed-income securities*.

A bond is always issued with a specific *face amount*, also called the *principal* or *par value*. Most often, simply because it’s convention, bonds are issued with face amounts of \$1,000. So, to raise \$50 million, Tommy would have to issue 50,000 bonds, each selling at \$1,000 par. Of course, he would then have to go out and find investors to buy his bonds.



REMEMBER

Every bond pays a certain rate of interest, and typically that rate is fixed over the life of the bond (hence, *fixed-income securities*). The *life of the bond* is the period of time until maturity. *Maturity*, in the lingo of financial people, is the date that the principal is due to be paid back. (Oh, yeah, the bond world is full of jargon.) The *rate of interest* is a percentage of the face amount and is typically (again, simply because of convention) paid out twice a year.

So, if a corporation or government issues a \$1,000 bond, paying 3.5 percent interest, that corporation or government promises to fork over to the bondholder \$35 a year — or, in most cases, \$17.50 twice a year. Then, when the bond matures — be it 1, 10, or 20 years down the road — the corporation or government repays the \$1,000 to the bondholder.

In some cases, you can buy a bond directly from the issuer and sell it back directly to the issuer. But you're more likely to buy a bond through a brokerage house or bank. You can also buy a basket of bonds through a company that packages bonds into bond funds, mutual funds, or exchange-traded funds (ETFs). These brokerage houses and fund companies will most certainly take a piece of the pie — and sometimes a quite sizable piece.

So far, so good?

In short, dealing in bonds isn't really all that different from the deal I worked out with Tommy Potts. It's just a bit more formal. Plus, the entire business is regulated by the Securities and Exchange Commission (SEC), among other regulatory authorities, and most bondholders — unlike me in the seventh grade — wind up getting paid back!

Choosing your time frame



REMEMBER

Almost all bonds these days are issued with life spans, or maturities, of up to 30 years. Few people are interested in lending their money for longer than that, and people young enough to think more than 30 years ahead rarely have enough money to lend. In bond lingo, bonds with a maturity of less than five years are typically referred to as *short-term bonds*, bonds with maturities of 5 to 12 years are called *intermediate-term bonds*, and bonds with maturities of 12 years or longer are called *long-term bonds*. With specific reference to Treasury securities, zero- to one-year maturities are bills, one- to ten-year maturities are notes, and ten years and longer are bonds.

In general (sorry, but you're going to read those words a lot in this book; bond investing comes with few hard-and-fast rules), the longer the maturity, the greater the interest rate paid. That's because bond buyers generally (there I go again) demand more compensation the longer they agree to tie up their money and assume whatever additional risk may come to bear over the years.

At the same time, bond issuers are willing to fork over more interest in return for the privilege of holding onto your money longer.

It's the same theory and practice with bank certificates of deposit (CDs): Typically, a two-year CD pays more than a one-year CD, which, in turn, pays more than a six-month CD.

The different rates that are paid on short-, intermediate-, and long-term bonds make up what's known as the *yield curve*. *Yield* refers to the annual payout on your investment. Because longer term bonds tend to pay more, the yield curve, when seen on a page, typically slopes up to the right. But sometimes the curve can be flat or, in rare instances, even slope downward (that's called *yield-curve inversion*). In Chapter 2, I provide an in-depth discussion of interest rates, bond maturity, and the all-important yield curve.

Picking who you trust to hold your money

Let's consider again the analogy between bonds and bank CDs. Both tend to pay higher rates of interest if you're willing to tie up your money for a longer period of time. But that's where the similarity ends.

When you give your money to a savings bank to plunk into a CD, that money — your principal — is almost certainly guaranteed (up to \$250,000 per account, per person, per ownership registration) by the Federal Deposit Insurance Corporation (FDIC). You can choose your bank because it's close to your house or because it gives lollipops to your kids, but if solid economics are your guide, your best bet is to open your CD where you're going to get FDIC insurance (almost all banks carry it) and the highest rate of interest. End of story. *Per person, per ownership registration*, in case you're wondering, means that a joint account would be insured up to \$500,000.



REMEMBER

Things aren't so simple in the world of bonds, where the FDIC does *not* insure your investment. In this world — and I can't emphasize this enough — a higher rate of interest isn't always the best deal. When you fork over your money to buy a bond, your principal, in most cases, is guaranteed only by the issuer of the bond. That “guarantee” is only as solid as the issuer itself. (Remember my seventh-grade experience?) That's why

U.S. Treasury bonds (guaranteed by the U.S. government) pay one interest rate, Microsoft bonds pay another rate, and Carnival Corp. bonds pay yet another rate. Can you guess where you'll get the highest rate of interest?

You'd expect the highest rate of interest to be paid by Carnival Corp. (Currently, in large part thanks to COVID-19, it's a somewhat shaky company.) Why? Because lending your money to the cruise line involves the risk that your money may sail off into oblivion. In other words, if the company sinks, you may lose a good chunk of your principal. That risk requires any shaky company to pay a relatively high rate of interest. Without being paid some kind of risk premium, you'd be unlikely to lend your money to a company that may not be able to pay you back. Conversely, the U.S. government, which has the power to levy taxes and print money, isn't going bankrupt anytime soon. Therefore, U.S. Treasury bonds, which are said to carry only an infinitely small risk of default, tend to pay the most modest interest rates. Often, the interest rate paid on Treasury bonds is referred to as the *risk-free rate*.

If Tommy Potts were to come to me for a loan today, needless to say, I wouldn't lend him money. Or if I did, I'd require a huge risk premium, along with some kind of collateral (more than his pet turtles). Bonds issued by the likes of Tommy Potts or Carnival Corp. — bonds that carry a relatively high risk of default — are commonly called *high-yield* or *junk bonds*. Bonds issued by solid companies and governments that carry little risk of default are commonly referred to as *investment-grade bonds*.

There are many, many shades of gray in determining the quality and nature of a bond. It's not unlike wine tasting in that regard. In Chapters 2 and 11, I give specific tips for “tasting” bonds and choosing the finest vintages for your portfolio.

Distinguishing bonds, stocks, and cryptocurrencies

Aside from the maturity and the quality of a bond, other factors can weigh heavily in how well a bond purchase treats you. In this book, I introduce you to such bond characteristics as *callability*, *duration*, and *correlation*, and I explain how the winds of the economy — and even the whims of the bond-buying public — can affect the returns on your bond portfolio.



REMEMBER

For the moment, I simply want to point out that, by and large, bonds' most salient characteristic — and the one thing that most bonds share — is a certain stability and predictability, well above and beyond that of most other investments. Because you are, in most cases, receiving a steady stream of income, and because you expect to get your principal back in one piece, bonds tend to be more conservative investments than, say, stocks, commodities, cryptocurrencies, and collectibles. In a typical year, the value of investment-grade bonds may rise or fall no more than the stock market will on an average day (or some cryptocurrencies will in an average hour!).

Is conservative a good thing? Sometimes. Sometimes not. It's true that many people (men more often than women, according to solid research) invest their money too aggressively, just as many people (regardless of gender) invest their money too conservatively. The appropriate portfolio formula depends on what your individual investment goals are and your personal taste for risk. I help you figure these out in Chapter 10.

Why Hold Bonds? (Spoiler Alert: It Isn't to Make You Rich)

In the real world, plenty of people own bonds — but often the wrong bonds in the wrong amounts and for the wrong reasons. Some people have too many bonds, making their portfolios too conservative; others have too few bonds, making their stock-heavy portfolios too volatile. Some have taxable bonds where they'd be better off with tax-free bonds, and vice versa. Others are so far out on a limb with shaky bonds that they may as well be lending their money to Tommy Potts.

The first step in building a bond portfolio — or any portfolio, for that matter — is to have clear investment objectives. (“I want to make money” — something I hear from clients all the time — is *not* a clear investment objective!) I help you develop clear objectives in Chapter 8. In the meantime, I want you to consider some of the typical reasons — both good and bad — why people buy and hold bonds.

Identifying the best reason to buy bonds: Diversification

Most people buy bonds because they perceive a need for steady income, and they think of bonds as the best way to get income without risking principal. This is one of the most common mistakes investors make: compartmentalization. They think of principal and interest as two separate and distinct money pools. They're not.

Let me clarify: Joe Typical buys a bond for \$1,000. At the end of six months, he collects an interest payment — income — of, say, \$25. He spends the \$25, figuring that his principal (the \$1,000) is left intact to continue earning money. At the same time, Joe buys a stock for \$1,000. At the end of six months, the price of his stock and, therefore, the value of his investment has grown to, say, \$1,025. Does he spend the \$25? No way. Joe reckons that spending any part of the \$1,025 is spending principal and will reduce the amount of money he has left working for him.

In truth, whether Joe spends his interest or his principal, whether he spends his income or generates cash flow from the sale of stock, he's left with the *very same* \$1,000 in his portfolio.



REMEMBER

Thinking of bonds, or bond funds, as the best — or only — source of cash flow or income can be a mistake. Bonds are a better source of steady income than stocks because bonds, in theory (and usually in practice), always pay interest; stocks may or may not pay dividends and may or may not appreciate in price. Bonds also may be a logical choice for people who need a certain sum of money at a certain point in the future — such as college tuition or cash for a new home — and can't risk a loss.

But unless you absolutely need a steady source of income, or a certain sum on a certain date, bonds may not be such a hot investment. Over the long haul, they have tended to return much less than stocks. I revisit this issue, and talk much more about the differences between stocks and bonds, in Chapter 10.



REMEMBER

For now, the point I want to make is that the far better reason to own bonds, for most people, is to *diversify* a portfolio. Simply put, bonds tend to zig when stocks zag, and vice versa. The key to truly successful investing is to have at least several different *asset classes* — different investment animals with different

characteristics — all of which can be expected to yield positive long-term returns but that do not all move up and down together.

There are very few assets classes — if any! — that serve as valiantly as bonds where it comes to diversifying a portfolio of stocks. History proves this, and you don't need to go back very far. In 2008, when the S&P 500 lost nearly 37 percent, U.S. Treasuries rose by 20 percent.

Going for the cash

Bonds aren't very popular with the get-rich-quick crowd — for good reason. The only people who get rich off bonds are generally the insiders who trade huge amounts and can clip the little guy. Nonetheless, certain categories of bonds — high-yield corporate (junk) bonds, for example — have been known to produce impressive gains.



WARNING

High-yield bonds may have a role — a limited one — in your portfolio. But know up front that high-yield bonds don't offer the potential long-term returns of stocks, and neither do they offer the portfolio protection of investment-grade bonds. Instead of zigging when the stock market is zagging, many high-yield bonds tend to zag right along with your stock portfolio. Be careful!

Some high-yield bonds are better than others — and they're held by relatively few people. I recommend those in Chapter 3.



REMEMBER

Even high-quality, investment-grade bonds are often purchased with the wrong intentions. A U.S. Treasury bond, though generally thought to be the safest bond of all, *doesn't guarantee your return of principal unless you hold it to maturity*. If you buy a 20-year bond and you want to know for sure that you're going to get your principal back, you'd better plan to hold it for 20 years. If you sell it before it matures, you may lose a bundle. Bond prices, especially on long-term bonds — yes, even Uncle Sam's bonds — can fluctuate greatly. I discuss the reasons for this fluctuation in Chapter 2.

I also discuss the complicated and often misunderstood concept of bond returns. You may buy a 20-year U.S. Treasury bond yielding 3 percent, and you may hold it for 20 years, to full maturity. Yes, you'll get your principal back, but you may actually earn more or less than 3 percent interest on your initial investment. It's complicated, but I explain this variation in a way you can understand — I promise! — in Chapter 2.

Introducing the Major Players in the Bond Market

Every year, millions — yes, literally millions — of bonds are issued by thousands of different governments, government agencies, municipalities, financial institutions, and corporations. They all pay interest. In many cases, the interest rates aren't all that much different from each other. In most cases, the risk that the issuer will *default* — fail to pay back your principal — is minute. So, why, as a lender of money, would you want to choose one type of issuer over another? Glad you asked!

Following are some important considerations about each of the major kinds of bonds, categorized by who issues them. I'm just going to scratch the surface right now. For a more in-depth discussion, see Chapter 3.

Supporting your Uncle Sam with Treasury bonds

Politicians like raising money by selling bonds, as opposed to raising taxes, because voters hate taxes. Of course, when the government issues bonds, it promises to repay the bond buyers over time. The more bonds the government issues, the greater its debt.

At the time of writing, the debt of the United States government is slightly more than \$30 trillion: almost \$91,000 for every U.S. citizen. (Yikes!) The interest payments on that debt currently total more than \$560 billion a year.

Some economists argue that the national debt will lead us to ruin. Others argue that because the government can print money, the only real danger of running too long in the red is inflation, and until there's runaway inflation, we needn't worry about it. We're not going to solve this debate here. Our focus is on the role that Treasury bonds may play in your portfolio.

In Chapter 3, I describe all the many kinds of Treasury bonds — from EE bonds to I bonds and T-bills to Treasury Inflation-Protected Securities (TIPS) — and the unique characteristics of each. For the moment, I merely want to point out that all of them are backed by the “full faith and credit” of the federal government.

Despite its huge debt, the United States of America isn't going bankrupt anytime soon. And for that reason, Treasury bonds have traditionally been referred to as "risk-free." Careful, though: The prices of Treasury bonds still fluctuate.



REMEMBER

When bond experts speak of Treasury bonds as having no risk, or almost no risk, what they mean is that the bonds have no *credit* risk. But Treasury bonds are very much subject to the other kinds of risk that beset most other bonds: interest-rate risk, inflation risk, and reinvestment risk. I discuss these types of risk in Chapter 9.

Collecting corporate debt

Bonds issued by for-profit companies are riskier than government bonds but tend to compensate for that added risk by paying higher rates of interest. (If they didn't, why would you or anyone else want to take the extra risk?) For the past few decades, corporate bonds in the aggregate have tended to pay about a percentage point higher than Treasuries of similar maturity. Since 2008, this spread has broadened, with ten-year corporate bonds paying about a percentage point and a half more than their governmental counterparts.



TIP

As you'll discover, I'm a big fan of diversification. It's especially important to diversify when dealing with any kind of investment that comes with default risk. For that reason, I don't like to see people plunk too great a percentage of their portfolios into any individual corporate bond. Wealthier investors — those with portfolios of \$1 million or more — can diversify by buying a collection of bonds. Savvy investors can temper their risks by familiarizing themselves with bond ratings and researching the issuing companies' bottom lines. But I generally advocate bond ownership — especially when it comes to corporate bonds — in bond funds. I discuss these funds at the end of this chapter and again, in greater depth, in Chapter 5.



WARNING

Oh, one more little thing about corporate bonds for the moment: They tend to get *called* a lot. That means that the corporation changes its incorporated mind about wanting your money and suddenly throws it back at you, redeeming the bond. Bond calls tend to happen when rates have fallen, and that's no fun. They add a dose of unpredictability to what should be a predictable investment.

Demystifying government and government-like agencies

Federal agencies, such as the Government National Mortgage Association (Ginnie Mae), and government-sponsored enterprises (GSEs), such as the Federal Home Loan Banks, issue a good chunk of the bonds on the market. Even though these bonds can differ quite a bit, they're collectively referred to as *agency bonds*. What we call agencies are sometimes part of the actual government, and sometimes a cross between government and private industry. In the case of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), they have been, following the mortgage crisis of 2008, somewhat in limbo.

To varying degrees, Congress and the Treasury would serve as protective big brothers if one of these agencies or GSEs were to take a financial beating and couldn't pay off its debt obligations.

In general, agency bonds are considered the next-safest thing to Treasury bonds. As such, the interest paid on these bonds is typically just a smidgen higher than the interest rate you would get on Treasuries of similar maturity, although in recent times, you can get a smidgen-plus. At the time of this writing, agency bonds maturing in 2032 were yielding about 4.16 percent versus 2.96 percent for Treasuries.



REMEMBER

By convention when financial people (I qualify) write about “Ginnie Mae bonds” or “Treasuries,” and there’s no specific mention of maturity, you can assume that the writer is referring to bonds with a ten-year maturity. That’s just the customary default. It’s like when a recipe calls for “sugar” without stipulating what kind of sugar. You just instinctively reach for white sugar.

I discuss agency bonds — the traditional kind of bonds these agencies offer — in Chapter 3. But many bonds that the federal agencies issue or guarantee are distinctly nontraditional in that they represent an ownership interest in pools of mortgages. These bonds, called *mortgage-backed securities*, are more complicated than traditional bonds. And I’m sorry to say that many people who invest in them haven’t the foggiest idea what they’re investing in — although some found out the hard way in late 2007 and 2008, when some of their mortgage-backed securities took a serious hit. Find out more about these babies in Chapter 3 as well.

Going cosmopolitan with municipal bonds

The bond market, unlike the stock market, is overwhelmingly institutional. In other words, most bonds are held by governments, insurance companies, money/asset managers, pension funds, and endowment funds. The only exception — the only kind of bond more popular with individual investors than institutions — is the municipal bond.

Municipal bonds (*munis* for short) are issued by cities, states, and counties. They're used to raise money for either the general day-to-day needs of the citizenry (schools, roads, sewer systems) or for specific projects (a new bridge, a sports stadium).

Munis' popularity with individual investors may be due in small part to the warm and fuzzy feelings to be had by investing in local infrastructure. But truth be told, their popularity stems much more from their special tax status.



REMEMBER

Interest on most municipal bonds is exempt from federal income tax. Interest on municipal bonds issued by your own city or state may be exempt from both federal *and* local taxes. Traditionally, the interest rates paid have been modest, but many individual investors — especially those in the higher tax brackets — often get a better after-tax return on municipal bonds than on comparable taxable bonds. In recent years, munis have tended to yield slightly more than Treasuries — even on a before-tax basis.

Like corporate bonds, but unlike Treasuries, municipal bonds are often subject to being called. You may *think* you're buying a ten-year investment, but you may be forced to relinquish the bond in two years instead. (Bond brokers must, per regulations, reveal this “defect,” and they usually do, but they certainly don't highlight it.)



REMEMBER

Municipal bonds tend to be less risky than corporate bonds but not as safe as Treasury and agency bonds. Just as corporate bonds are given ratings, so are municipal bonds. It's important to know before investing whether the local government issuing a bond has the wherewithal to pay back your principal. Cities don't go bankrupt often, but it does happen. And some pundits have expressed fears that, in the future, more municipalities than ever may declare bankruptcy. (That fear is part of what's driven up the yield on these bonds.) I reveal more on munis in Chapter 3.

Buying Solo or Buying in Bulk

One of the big questions about bond investing that I help you answer later in this book is whether to invest in individual bonds or bond funds.



REMEMBER

I generally advocate bond funds — both bond mutual funds and ETFs. Mutual funds and ETFs represent baskets of securities (usually stocks or bonds, or sometimes both) and allow for instant and easy portfolio diversification. You do, however, need to be careful about which funds you choose. Not all are created equal — far, far from it.

I outline the pros and cons of owning individual bonds versus bond funds in Chapter 11. Here, I give you a quick sneak preview of that discussion.

Picking and choosing individual bonds

Individual bonds offer investors the opportunity to really fine-tune a fixed-income portfolio. With individual bonds, you can choose exactly what you want in terms of bond quality, maturity, and taxability.

For larger investors — especially those who do their homework — individual bonds may also be more economical than your average bond fund. But that's only true for investors who are up on the latest advances in bond buying and selling.

Once upon a time, any buyers or sellers of individual bonds had to take a giant leap of faith that their bond broker wasn't trimming too much meat off the bone. No more. In Chapter 4, I show you how to find out exactly how much your bond broker is making off you — or trying to make off you. I show you how to compare comparable bonds to get the best deals. And I discuss some popular bond strategies, including the most popular and potent one — *laddering* your bonds, which means staggering the maturities of the bonds you buy.

Going with a bond fund or funds

Investors now have a choice of hundreds of bond mutual funds and ETFs. Most have the same basic drawbacks: management

expenses and a certain degree of unpredictability above and beyond individual bonds. But even so, many make for good investments.

Where to begin your fund search? I promise to help you weed out the losers and pick the best. As you'll discover (or as you know already if you've read my book *Exchange-Traded Funds For Dummies* [Wiley]), I'm a strong proponent of buying *index funds* — mutual funds or ETFs that seek to provide exposure to an entire asset class (such as bonds or stocks) with little trading and low expenses. Especially now with interest rates so low, keeping your expenses rock-bottom is crucial. Index funds are the way to go for most investors to get the bond exposure they need. I suggest some good bond index funds, as well as other bond funds, in Chapter 5.



TIP

If you'd like to know more about funds in general, pick up copies of the latest editions of *Exchange-Traded Funds For Dummies* and Eric Tyson's *Mutual Funds For Dummies* (Wiley).

The Triumphs and Failures of Fixed-Income Investing

Picture yourself in the year 1926. Calvin Coolidge occupies the White House. Ford's Model T can be bought for \$200. Charles Lindbergh is gearing up to fly across the Atlantic. And you, having just arrived from your journey back in time, brush the time-travel dust off your shoulders and reach into your pocket. You figure that if you invest \$100, you can then return to the present, cash in on your investment, and live like a corrupt king. So, you plunk down the \$100 into some long-term government bonds.

Fast-forward to the present, and you discover that your original investment of \$100 is now worth \$16,180. It grew at an average annual compound rate of return of about 5.5 percent. (In fact, that's just what happened in the real world.) Even though you aren't rich, \$16,180 doesn't sound too shabby. But you need to look at the whole picture.

Beating inflation, but not by very much

Yes, you enjoyed a return of 5.5 percent a year, but while your bonds were making money, inflation was eating it away — at a rate of about 2.9 percent a year. What that means is that your

\$16,180 is really worth only about \$1,070 in 1926 dollars. Your investment, your \$100, in *real* terms (inflation-adjusted dollars) actually grew about 10.7 times.

To put that another way, your real (after-inflation) yearly rate of return for long-term government bonds was about 2.53 percent. In about half of the 95 years, your bond investment either didn't grow at all in real-dollar terms or actually lost money.

Compare that scenario to an investment in stocks. Had you invested the very same \$100 in 1926 in the S&P 500 (500 of the largest U.S. company stocks), your investment would've grown to \$855,668 in *nominal* (preinflation) dollars. In 1926 dollars, that would be \$56,200. The average nominal return was 10 percent, and the average real annual rate of return for the bundle of stocks was 6.9 percent. Your investment in real dollars grew not 10.7 times (the case with bonds), but about 562 times. (Those rates ignore both income taxes and the fact that you can't invest directly in an index, but they're still valid for comparison purposes.)

So, which would you rather have invested in: stocks or bonds? Obviously, stocks were the way to go. In comparison, bonds seem to have failed to provide adequate return.

Providing help in times of distress

But hold on. There's another side to the story. Yes, stocks clobbered bonds over the course of the past nine or ten decades. But who makes an investment and leaves it untouched for that long? Rip Van Winkle maybe. But outside of fairy-tale characters, no one does. Real people in the real world usually invest for much shorter periods. And there have been some shorter periods over the past nine or ten decades when stocks have taken some stomach-wrenching falls.

The worst of all falls, of course, was during the Great Depression that began with the stock market crash of 1929. Any money that your grandparents or great-grandparents may have had in the stock market in 1929 was worth not even half as much four years later. Over the next decade, stock prices would go up and down, but Grandma and Grandpa wouldn't see their \$100 back until about 1943. Had they planned to retire in that period, well, they may have had to sell a few apples on the street just to make ends meet.

A bond portfolio, however, would've helped enormously. Had Grandma and Grandpa had a diversified portfolio of, say, 70 percent stocks and 30 percent long-term government bonds, they would've been pinched by the Great Depression but not destroyed. Although \$70 of stock in 1929 was worth only \$33 four years later, \$30 in long-term government bonds would've been worth \$47. All told, instead of having a \$100 all-stock portfolio fall to \$46, their 70/30 diversified portfolio would've fallen only to \$80. Big difference!

Closer to our present time, a \$10,000 investment in the S&P 500 at the beginning of 2000 was worth only \$5,800 after three years of a growly bear market. But during those same three years, long-term U.S. government bonds soared. A \$10,000 70/30 (stock/bond) portfolio during those three years would've been worth \$8,210 at the end. Another big difference!

In 2008, as you're well aware, stocks took another big nosedive. The S&P 500 tumbled 37 percent in that dismal calendar year. And long-term U.S. government bonds? Once again, our fixed-income friends came to the rescue, rising nearly 26 percent. In fact, nearly every investment imaginable, including all the traditional stock-market hedges, from real estate to commodities to foreign equities, fell hard that year. Treasury bonds, however, continued to stand tall.

And closest to home, when it became clear that the world was facing a COVID-19 pandemic, from February through the end of March 2020, the S&P declined over the course of a month by 34 percent. Over that same period, the iShares 7–10 Year Treasury Bond ETF (IEF) increased in value by roughly 6 percent.



REMEMBER

Clearly, long-term government bonds can, and often do, rise to the challenge during times of economic turmoil. Why are bad times often good for many bonds? I explain the reasons for this phenomenon in Chapters 2 and 3. For now, know that bonds have historically been a best friend to investors when investors have most needed a friend. Given that bonds have saved numerous stock investors from impoverishment, bond investing in the past eight to nine decades may be seen not as a miserable failure but as a huge success.

Realizing How Crucial Bonds Are Today

I could talk about the importance of corporate debt to the growth of the economy, the way in which municipal bonds help to repair roads and build bridges, and how Ginnie Mae and Fannie Mae bonds help to provide housing to the masses, but I think I'll just let this one sentence suffice. This is, after all, not a book on macroeconomics and social policy but a book on personal investing. So, allow me to address the crucial role that bonds play in the lives of individual investors — people like you and me.

With roughly 25 percent of their portfolios invested in fixed income, U.S. households' economic welfare is closely tied to the fortunes of the bond market.



REMEMBER

I would argue that with the demise of the traditional pension over the past decades, bond investing became more important than ever. Back when you knew your company would take care of you in old age, you may have played footloose and fancy-free with your portfolio without having to worry that a scrambled nest egg might mean you couldn't afford to buy eggs. Today, a well-tuned portfolio — that almost certainly includes a good helping of bonds — can make the difference between living on Easy Street and living *on* the street.

Keep in mind that most of the money in the bond market today is institutional money. If you have a life insurance policy, chances are that your life insurance company has most of your future payoff invested in bonds. If you have money in your state's prepaid college tuition program, chances are that your money is similarly indirectly invested in bonds. If you're one of the fortunate people whose employer still offers a pension, chances are that your employer has your future pension payout invested in bonds.

In total, about \$124 trillion is invested in bonds worldwide at the time of this writing, and the amount is growing year by year. Many economists speculate that as the baby boomer generation continues to move into retirement, the demand for income-generating investments like bonds will only grow. If you live and work in a developed nation, your economic well-being is much more closely tied to the bond markets than you think.

Viewing Recent Developments, Largely for the Better

As the prices of everything from groceries and gas to college tuition and medical care continue to climb, it's nice to know that at least two things on this planet have gotten cheaper in the past few years: computers and bond trades. And as any seasoned bond investor will tell you, saving money on trades isn't the only exciting development of late. Here are some others worth noting:

» **New and better bond funds:** According to Morningstar Direct, you have almost 2,500 bond funds in which you can invest at the time of this writing. (If I were to include various "classes" of these funds, such as many mutual-fund companies offer, basically for small investors and large investors, the number would be well over 7,000.) Of these, roughly 400 are *bond index funds* — funds that seek to capture the returns of an entire swath of the bond market — which, from my vantage point, tend to be the best options for most bond investors. These funds carry an average yearly expense ratio of 26 basis points (26/100 of 1 percent), which is way, way less than most bond funds. (The average for nonindex bond mutual funds is 85 basis points.)



TIP

The newest kid on the block, ETFs — somewhat similar to mutual funds — are the greatest thing to happen to bond investing in a very long time. ETFs allow small investors to invest like the big boys, with extremely low expenses and no minimum investment requirements. As of this printing, more than 500 bond ETFs exist. Some of them carry annual expense ratios so low as to be laughable. (How often is it that you get to laugh all the way to the bank?)

I discuss both ETFs and mutual funds in Chapter 5.

» **Greater access to information:** One of the advantages of all index funds, but especially ETFs over traditional actively managed mutual funds, is their relative *transparency*. That means that when you invest in an ETF, you know exactly what you're buying. Traditional mutual funds aren't required to reveal their specific investments; you may think you're buying one thing and end up with another.

When it comes to buying and selling individual bonds, it's as if a muddy pond has been transformed into a glass aquarium. Not long ago, a bond broker would give you a price for a bond, and you'd have absolutely no idea how fair a deal you were getting. Nowadays, you can search online and usually get a very good idea of how fair a deal you're getting, how much the broker is making, and whether better deals can be had. I give you a complete tour of the aquarium in Chapter 4.

» **The expansion of Uncle Sam's treasury chest:** If you're going to invest in individual bonds, U.S. Treasury bonds may make the most sense. The Treasury now has a website (www.treasurydirect.gov) where you can buy its bonds directly and not have to deal with any brokers whatsoever, nor will you need to fork over any kind of markup. I walk you through the process in Chapter 3.



TIP

One special kind of Treasury bond — TIPS — has been in existence since the mid-1990s. An exciting development in the world of bonds, TIPS offer only modest interest rates, but the principal is readjusted twice annually to keep up with inflation. TIPS represent an entirely new *asset class* (kind of investment), and I advocate that most of my clients hold at least one-quarter of their bond allocation in TIPS. They can be important portfolio diversifiers. Read all about them in Chapter 3.

» **Internationalization of the bond market:** The U.S. government isn't the only government to issue bonds. U.S. corporations aren't the only corporations to issue bonds either. For added portfolio diversification, and possibly a higher yield, you may want to look abroad. Until recently, international diversification in fixed income was difficult. Now it's as easy as (but not as American as) apple pie. As with U.S. bonds, you have your pick of short-term or long-term bonds, safe-and-simple bonds, or risky-with-high-return potential bonds. You can invest in the relatively calm waters of the United Kingdom, Japan, or Germany. Or you can travel to countries such as Mexico, Brazil, and Russia, where the bond markets are choppy and exciting. Join me on the voyage abroad in Chapter 3.

NEED A HOBBY? TRY SCRIPOPHILY

The term *scripophily* (pronounced *scrip awful lee*) derives from a contest held by the *Financial Times* newspaper in 1978 to come up with an appropriate name for collecting antique stocks and bonds. Bob Kerstein, CEO of Scripophily.com, estimates that the hobby boasts 20,000 to 30,000 enthusiasts in the United States alone.

Kerstein's website (www.scripophily.com) features more than 17,000 old certificates from various nations, industries, and eras. Many of them are works of art, some even featuring paintings from famous artists of their day. But the majority of the old stocks and bonds have one thing in common, says Kerstein: "They may be valuable as collector items, but they are usually worthless as redeemable securities." He says he's seen scams whereby con artists try to sell old corporate bonds (both domestic and international) as redeemable securities, even though they have no market value, other than as collectibles. "Those old bonds may look like they're still redeemable, but they are not," he warns.

Liberty Bonds, sold during World War I, are *very* popular among collectors — much more popular than when they were first issued. (The lack of consumer enthusiasm for them proved to be a bit of an embarrassment to the U.S. Treasury; unlike World War II, which rallied tremendous public support, World War I wasn't very popular among Americans.) Kerstein advises, "If you happen to have a Liberty Bond, don't cash it in with the government — a collector might pay you many times as much as the government."