Making Everything Easier!™

Investing in Bonds FOR DUMMIES®

A Wiley Brand

Learn to:

- Buy and sell bonds and bond funds
- Measure the risk and returns that bonds offer
- Diversify your investment portfolio by adding bonds
- Avoid common investment mistakes

Russell Wild

NAPFA Certified Financial Advisor

Introduction

Welcome to *Investing in Bonds For Dummies!* Perhaps you bought this book online, either in text or digital format. But if you are still the kind of reader who prefers to browse through aisles and handle books before you buy them, you may be standing in the Personal Finance section of your favorite bookstore right now. If so, take a look to your left. Do you see that pudgy, balding guy in the baggy jeans perusing the book on getting rich by day-trading stock options? Now look to your right. Do you see that trendy young woman with the purple lipstick and hoop earrings thumbing through that paperback on how to make millions in foreclosed property deals? I want you to walk over to them. Good. I want you to take this book firmly in your hand. Excellent. Now smack each of them over the head with it. Nice job!

Wiley (the publisher of this book) has lawyers who will want me to assure you that I'm only kidding about smacking anyone. So in deference to the attorneys, and because I want to get my royalty checks … I'm kidding! I'm only kidding! Don't hit anyone!

But the fact is that *someone* should knock some sense into these people. If not, they may wind up — as do most people who try to get rich quick — with big holes in their pockets.

Those who make the most money in the world of investments possess an extremely rare commodity in today's world — something called patience. At the same time that they're looking for handsome returns, they are also looking to protect what they have. Why? Because a loss of 75 percent in an investment (think tech stocks

2000–2002) requires you to earn *400 percent* to get back to where you started. Good luck getting there!

In fact, garnering handsome returns and protecting against loss go hand in hand, as any financial professional should tell you. But only the first half of the equation — the handsome returns part — gets the lion's share of the ink. Heck, there must be 1,255 books on getting rich quick for every one book on limiting risk and growing wealth slowly but surely.

Welcome to that one book: *Investing in Bonds For Dummies.*

So just what are bonds? A *bond* is basically an IOU. You lend your money to Uncle Sam, to General Electric, to Procter & Gamble, to the city in which you live — to whatever entity issues the bonds — and that entity promises to pay you a certain rate of interest in exchange for borrowing your money.

This is very different from stock investing, where you purchase shares in a company, become an alleged partial owner of that company, and then start to pray that the company turns a profit and the CEO doesn't pocket it all.

Stocks (which really aren't as bad as I just made them sound) and bonds complement each other like peanut butter and jelly. Bonds are the peanut butter that can keep your jelly from dripping to the floor. They are the life rafts that can keep your portfolio afloat when the investment seas get choppy. Yes, bonds are also very handy as a source of steady income, but, contrary to popular myth, that should not be their major role in most portfolios.

Bonds are the sweethearts that may have saved your grandparents from selling apples on the street during the hungry 1930s. (Note that I'm not talking about high-

yield "junk" bonds here.) They are the babies that may have saved your 401(k) from devastation during the three growly bear-market years on Wall Street that started this century. In 2008, high-quality bonds were just about the only investment you could have made that wound up in the black at a time when world markets frighteningly resembled the Red Sea. And in 2011, when stocks went just about nowhere during the course of the year, bondholders of nearly all kinds were richly rewarded.

Bonds belong in nearly every portfolio. Whether or not they belong in *your* portfolio is a question that this book will help you to answer.

About This Book

Allow the next 270 or so pages to serve as your guide to understanding bonds, choosing the right bonds or bond funds, getting the best bargains on your purchases, and achieving the best prices when you sell. You'll also find out how to work bonds into a powerful, well-diversified portfolio that serves your financial goals much better (I promise) than day-trading stock options or attempting to make a profit flipping real estate in your spare time.

I present to you, in easy-to-understand English (unless you happen to be reading the Ukrainian or Korean translation), the sometimes complex, even mystical and magical world of bonds. I explain such concepts as bond maturity, duration, coupon rate, callability (yikes), and yield; and I show you the differences among the many kinds of bonds, such as Treasuries, agency bonds, corporates, munis, zeroes, convertibles, strips, and TIPS.

Since I wrote the first edition of this book, the number and types of bond funds in which investors can now sink

their money has virtually exploded … for better or worse. Many of these new funds (mostly exchange-traded funds) are offering investors slices of the bond market, often packaged in a way that makes bond investing trickier than ever.

And perhaps the biggest change since the first edition of this book was published is this: Interest payments — the main reason that bonds exist — have plummeted to historic lows. Never in our lifetimes — or our parents' lifetimes — have we seen the negative "real returns" (after-inflation returns) that some bonds have been offering.

In this book, you discover the mistakes that many bond investors make, the traps that some wily bond brokers lay for the uninitiated, and the heartbreak that can befall those who buy certain bonds without first doing their homework. (Don't worry — I walk you through how to do your homework.) You find out how to mix and match your bonds with other kinds of assets — such as stocks and real estate — taking advantage of the latest in investment research to help you maximize your returns and minimize your risk.

Here are some of the things that you need to know before buying any bond or bond fund — things you'll know after you read this book:

- **What's your split gonna be?** Put all your eggs in one basket, and you're going to wind up getting scrambled. A key to successful investing is diversification. Yes, you've heard that before — so has everyone — but you'd be amazed how many people ignore this advice!

  Unless you're working with really exotic investments, the majority of most portfolios is invested in stocks

and bonds. The split between those stocks and bonds — whether you choose an 80/20 (aggressive) portfolio (composed of 80 percent stocks and 20 percent bonds), a 50/50 (balanced) portfolio, or a 20/80 (conservative) portfolio — is very possibly *the single most important investment decision you'll ever make.*

- **What kind of bonds do you want?** Depending on your tax bracket, your age, your income, your financial needs and goals, your need for ready cash, and a bunch of other factors, you may want to invest in Treasury, corporate, agency, or municipal bonds. Within each of these categories, you have other choices to make: Do you want long-term or short-term bonds? Higher-quality bonds or higher yielding bonds? Freshly issued bonds or bonds floating around on the secondary market? Bonds issued in the United States or bonds from Mexico or Brazil?
- **Where do you shop for bonds?** Although bonds have been around more or less in their present form for hundreds of years, the way they are bought and sold has changed radically in recent years. Bond traders once had you at their tender mercy. You had no idea what kind of money they were clipping from you every time they traded a bond, allegedly on your behalf. That is no longer so. Whether you decide to buy individual bonds or bond funds, you can now determine almost to the dime how much the hungry middlemen intend to nibble — or have nibbled from your trades in the past.
- **What kind of returns can you expect from bonds, and what is your risk of loss?** Here is the part of bond investing that most people find most confusing — and, oh, how misconceptions abound! (You can't lose money in AAA-rated bonds? Um … How can I break this news to you gently?) I explain the tricky

concepts of duration and yield. I tell you why the value of your bonds is so directly tied to prevailing interest rates — with other economic variables giving their own push and pull. I give you the tools to determine just what you can reasonably expect to earn from a bond, and under what circumstances you may lose money.

Foolish Assumptions

I assume that you are intelligent, that you have a few bucks to invest, and that you have a basic education in math (and maybe a very rudimentary knowledge of economics) — that's it.

In other words, even if your investing experience to date consists of opening a savings account, balancing a checkbook, and reading a few Suze Orman columns, you should still be able to follow along. Oh, and for those who are already buying and selling bonds and feel completely comfortable in the world of fixed income, I'm assuming that you, too, can learn something from this book. (Oh? You know it all, do you? Can you tell me what a *sukuk* is, or where to buy one, huh? See Chapter 3!)

Icons Used in This Book

Throughout the book, you'll find little cartoons in the margins. In the *Dummies* universe, these are known as *icons,* and they signal certain (we hope) exciting things going on in the accompanying text.

Although this is a how-to book, you'll also find plenty of whys and wherefores. Any paragraph accompanied by this icon, however, is guaranteed to be at least 99.99 percent how-to.

Read twice! This icon indicates that something important is being said and is really worth committing to memory.

The world of bond investing — although generally not as risky as the world of stock investing — still offers pitfalls galore. Wherever you see the bomb, you'll know that danger — of losing money — lies ahead.

If you don't really care how to calculate the after-tax present value of a bond selling at 98, yielding 4.76 percent, maturing in 9 months, and subject to AMT, but instead you're just looking to gain a broad understanding of bond investing, feel free to skip or skim the denser paragraphs that are marked with this icon.

Beyond the Book

In addition to all the material you can find in the book you're reading right now, this product also comes with some access-anywhere goodies on the web. Check out the eCheat Sheet at www.dummies.com/cheatsheet/investinginbonds for helpful

insights and details about the history of war bonds, collecting unusual bonds, using CUSIP to identify bonds, and how to calculate your minimum required distribution (MRD) in retirement.

And check out `www.dummies.com/extras/investinginbonds` for some more free extra content. There you'll find articles on such topics as how the Fed moves interest rates, buying a primary or secondary bond issue, choosing between index funds and active mutual funds, and matching your portfolio to your longevity.

Where to Go from Here

Where would you like to go from here? If you want, start at the beginning. If you're mostly interested in municipal bonds, hey, no one says that you can't jump right to Chapter 8. Global bonds? Go ahead and jump to Chapter 9. It's entirely your call. Maybe start by skimming the index at the back of the book.

If you've ever read one of these black and yellow *For Dummies* books before, you know this is not a book you need to read from front to back, or (if you're reading the Chinese or Hebrew edition) back to front. Feel free to jump back and forth in order to glean whatever information you think will help you the most. No proctor with bifocals will pop out of the air, Harry Potter–style, to test you at the end. You needn't commit it all to memory now — or ever. Keep this reference book for years to come as your little acorn of a bond portfolio grows into a mighty oak.

Part I
Bond Apetit!

Visit www.dummies.com for great Dummies content online.

In this part ...

- Check out the bottom-line basics of bonds and bond fundamentals
- Get interested in interest, find out all about yield, and get the scoop on total return
- Study the different types of bonds: savings bonds, Treasury bonds, corporate bonds, agency bonds, municipal bonds, and more

Chapter 1
The Bond Fundamentals

In This Chapter

- Getting a handle on the nature of bonds
- Knowing why some bonds pay more than others
- Understanding the rationale behind bond investing
- Meeting the major bond issuers
- Considering individual bonds versus bond funds

Long before I ever knew what a bond is (it's essentially an IOU), I agreed to lend five dollars to Tommy Potts, a blond, goofy-looking kid in my seventh-grade class. This was the first time that I'd ever lent money to anyone. I can't recall why Tommy needed the five dollars, 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. So I approached 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 would 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 — five dollars." At which point, Mr. Potts neither lectured

nor reached for his wallet. Rather, he erupted into mocking laughter. "You lent *him* money!" he bellowed repeatedly, laughing, slapping his thighs, and pointing to his turtle-torturing 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 five dollars 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 is convention, bonds are issued with face amounts of $1,000. So in order 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.

Every bond pays a certain rate of *interest,* and typically (but not always) 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 period of time until the principal is due to be paid back. (Yes, 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 4-percent interest, that corporation or government promises to fork over to the bondholder $40 a year — or, in most cases, $20 twice a year. Then, when the bond matures, 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 a bank. You can also buy a basket of bonds through a company that sells mutual funds or exchange-traded funds. These brokerage houses and fund companies will most certainly take a piece of the pie — sometimes a quite sizeable piece.

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. And the entire business is regulated by the Securities and Exchange Commission (among other regulatory authorities), and most (but not all) bondholders — unlike me — wind up getting paid back!

Choosing your time frame

Almost all bonds these days are issued with life spans (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.* Bonds with maturities of 12 years or longer are called *long-term 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. 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 exactly the same theory and practice with bank CDs (Certificates of Deposit): 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 bonds make up what is known as the *yield curve. Yield* simply refers to the annual interest rate. 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) by the Federal Deposit Insurance Corporation (FDIC). If solid economics be your guide, you should 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.

Things aren’t so simple in the world of bonds. 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. That’s why U.S. Treasury bonds (guaranteed by the U.S. government) pay one interest rate, General Electric bonds pay another rate, and RadioShack bonds pay yet another rate. Can you guess where you’ll get the highest rate of interest?

You would expect the highest rate of interest to be paid by RadioShack. Why? Because lending your money to RadioShack, which has been busy closing stores left and right, involves the risk that company HQ may close, as well.. In other words, if the company goes belly up, 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 would 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, is not going bankrupt any time soon. Therefore, U.S. Treasury bonds, which are said to carry only an infinitely small risk of *default,* tend to pay relatively modest interest rates.

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 would 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 RadioShack — 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 very 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 Chapter 2, and again in Chapter 11, I give many specific tips for "tasting" bonds and choosing the finest vintages for your portfolio.

Differentiating among bonds, stocks, and Beanie Babies

Aside from the maturity and the quality of a bond, other factors could weigh heavily in how well a bond purchase treats you. In the following chapters, 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.

For the moment, I simply wish to point out that, by and large, bonds' most salient characteristic — and the one thing that most, but not all 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, or collectibles.

Is conservative a good thing? Not necessarily. It's true that many people (men, more often than women) invest their money too aggressively, just as many people (of both genders) invest their money too conservatively. The

appropriate portfolio formula depends on what your individual investment goals are. I help you to figure that out in Chapter 10.

By the way, my comment about men investing more aggressively is not my personal take on the subject. Some solid research shows that men do tend to invest (as they drive) much more aggressively than do women.

Why Hold Bonds? (Hint: You'll Likely Make Money!)

In the real world, plenty of people own plenty of 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; some have too few bonds, making their stock-heavy portfolios too volatile. Some have taxable bonds where they should have 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 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!) Here are 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 are not.

Let me explain: 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.

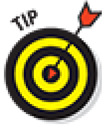
In truth, whether Joe spends his "interest" or his "principal," whether he spends his "income" or generates "cash flow" from the sale of stock, he is left with the *very same* $1,000 in his portfolio.

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 may 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 tend to return much less than stocks. I revisit this issue,

and talk much more about the differences between stocks and bonds, in Chapter 10.



For now, the point I wish 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.

Going for the cash

Bonds are not 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.

High-yield bonds may have a role — a limited one — in your portfolio, as I discuss in Chapter 3. But know up front that high-yield bonds do not offer the potential long-term returns of stocks, and neither do they offer the portfolio protection of investment-grade bonds. Rather than zigging when the stock market zags, many high-yield bonds zag right along with your stock portfolio. Be careful!

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

Even high quality, investment-grade bonds are often purchased with the wrong intentions. Note: A U.S. Treasury bond, though generally thought to be the safest bond of all, *will not 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 had 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 very 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. And yes, you'll get your principal back, but you may actually earn far more or far less than 3 percent interest on your money! It's complicated, but I explain this phenomenon 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. In the meantime, here are the basics:

- **Supporting (enabling?) your Uncle Sam with Treasury bonds:** When the government issues bonds, it promises to repay the bond buyers over time. The more bonds the government issues, the greater its debt. Voters may groan about the national debt, but they generally don't see it as an immediate problem.

  In Chapter 3, I explain all of the many, many kinds of Treasury bonds — from EE Bonds to I Bonds to 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 is not going bankrupt anytime soon. And for that reason, Treasury bonds have traditionally been referred to as "risk-free." Careful! That does *not* mean that the prices of Treasury bonds do not fluctuate.

- **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 third more than their governmental counterparts.

- **Demystifying those 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 are 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 will 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.

- **Going cosmopolitan with municipal bonds:** The bond market, unlike the stock market, is overwhelmingly institutional. In other words, most bonds are held by insurance companies, pension funds, endowment funds, and mutual funds. The only exception is the municipal bond market.

  Municipal bonds (*munis*) are issued by cities, states, and counties. They are 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).

Buying Solo or Buying in Bulk

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

I generally advocate bond funds — both bond mutual funds and exchange-traded funds. Mutual funds and exchange-traded funds 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 very 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 — investing in individual bonds may also be more economical than investing in a bond fund. That's especially 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 that you buy.

Going with a bond fund or funds

Investors now have a choice of well over 5,000 bond mutual funds or exchange-traded funds. All have the same basic drawbacks: management expenses and a certain degree of unpredictability above and beyond individual bonds. But even so, some make for very good potential investments, particularly for people with modest portfolios.

Where to begin your fund search? I promise to help you weed out the losers and pick the very best. As you'll discover (or as you know already if you have read my *Exchange-Traded Funds For Dummies*), I'm a strong proponent of buying *index funds* — mutual funds or exchange-traded funds that seek to provide exposure to an entire asset class (such as bonds or stocks) with very little trading and very low expenses. I believe that such 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.

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 $11,730. It grew at an average annual compound rate of return of 5.5 percent. (In fact, that's just what happened in the real world.) Even though you aren't rich, $11,730 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 3.0 percent a year. What that means is that your $11,730 is really worth about $885 in 1926 dollars.

To put that another way, your real (after-inflation) yearly rate of return for long-term government bonds was about 2.5 percent. In about half of the 89 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 have grown to $567,756 in *nominal* (pre-inflation) dollars. In 1926 dollars, that would be

about $42,800. The average nominal return was 10.2 percent, and the average real annual rate of return for the bundle of stocks was 7.0 percent. (Those rates ignore both income taxes and the fact that you can't invest directly in an index, but they are 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.

Saving the day when the day needed saving

But hold on! There's another side to the story! Yes, stocks clobbered bonds over the course of the last eight or nine 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! Real people in the real world usually invest for much shorter periods. And there have been some shorter periods over the past eight or nine 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 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 have helped enormously. Had Grandma and Grandpa had a diversified portfolio of, say, 70 percent stocks and 30 percent long-term government bonds, they would have been pinched by the Great Depression but not destroyed. While $70 of stock in 1929 was worth only $33 four years later, $30 in long-term government bonds would have been worth $47. All told, instead of having a $100 all-stock portfolio fall to $46, their 70/30 diversified portfolio would have 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 have been worth $8,210 at the end. Another big difference.

In 2008, as you’re well aware, stocks took a 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.

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? Bonds have historically been a best friend to investors at those times 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.

Gleaning some important lessons

Bonds have been a bulwark of portfolios throughout much of modern history, but that's not to say that money — some serious money — hasn't been lost. In this section, I offer examples of some bonds that haven't fared well so you're aware that even these relatively safe investment vehicles carry some risk.

Corporate bonds

Corporate bonds — generally considered the most risky kind of bonds — did not become popular in the United States until after the Civil War, when many railroads, experiencing a major building boom, had a sudden need for capital. During a depression in the early to mid 1890s, a good number of those railroads went bankrupt, taking many bondholders down with them. Estimates indicate that more than one out of every three dollars invested in the U.S. bond market was lost. Thank goodness we haven't seen anything like that since (although during the Great Depression of the 1930s, plenty of companies of all sorts went under, and many corporate bondholders again took it on the chin).

In more recent years, the global bond default rate has been less than 1 percent a year. Still, that equates to several dozen companies a year. In recent years, a number of airlines (Delta, Northwest), energy companies (Enron), and one auto parts company (Delphi) defaulted on their bonds. Both General Motors and Ford, as well as RadioShack experienced big downgrades (from *investment-grade* to *speculative-grade,* terms I explain in

Chapter 2), costing bondholders (especially those who needed to cash out holdings) many millions.

Lehman Brothers, the fourth largest investment bank in the United States, went belly up in the financial crisis of 2008. Billions were lost by those in possession of Lehman Brothers bonds. (Many more billions were also lost in mortgage-backed securities and collateralized debt obligations. These investments are debt instruments issued by financial corporations, but they are very different animals than typical corporate bonds and rarely spoken of in the same breath. I'll get to those in Chapter 5.) Most recently, we've witnessed the collapse of once very healthy corporations, from Borders to Sharper Image to Kodak. Even Hostess became little more than crumbs. (It's tough to imagine that with our insatiable appetite for sugary snacks, a company could lose money on Ding Dongs and Twinkies!) As we've seen time and time again, corporations sometimes go under. None are too big to fail.

Municipal bonds

Municipal bonds, although much safer overall than typical corporate bonds, have also seen a few defaults. In 1978, Cleveland became the first major U.S. city to default on its bonds since the Great Depression. Three years prior, New York City likely would have defaulted on its bonds had the federal government not come to the rescue.

The largest default in the history of the municipal bond market occurred in 2013, when Detroit declared bankruptcy, leaving holders of more than $8 billion in bonds wondering (and, at the time of this writing, they are wondering still) if they will ever their money back.

Largely due to the situation in Detroit, there has been lots of talk about municipal bankruptcies of late. Yet not