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HOW TO GET BURNED WITH BONDS

The bond market has performed well for the past three decades. The primary driver of this good performance has been the decline in interest rates. Interest rates peaked in 1982 and have fallen almost steadily ever since. As rates fall, bond prices rise, adding to their total returns.

History demonstrates, however, that interest rates can also rise for long periods of time, and so cause bonds to deliver abysmal returns. The following is an example of such a period.

> **Over the 36-year period between the end of 1945 and the end of 1981, the interest rate, or coupon income, on U. S. Government bonds averaged 4.9% per year. Over the same period, however, the prices of U. S. Government bonds declined at an average rate of 3.0% per year, producing an average total return of 1.9% per year. Inflation over this period averaged 4.7% per year, resulting in a "real" or inflation-adjusted total return of -2.8% per year.**
>
> **The average annual total return on common stocks over this period was 10.3% per year. Subtracting 4.7% for inflation left a "real" return that averaged +5.6% per year, 8.4% per year greater than the return on bonds.**
>
> **$100,000 invested at -2.8% per year resulted in $36,000 in purchasing power 36 years later. Invested at 5.6% per year, $100,000 resulted in $711,000 in purchasing power 36 years later, an outcome greater by a factor of nearly twenty (19.8x).**

With gargantuan federal deficits, with an historically high and rapidly growing national debt, with short-term interest rates near zero, and with long-term interest rates having hit near-historic lows, it appears likely that bonds are in a bubble and that we may be about to enter into another era of catastrophic bond returns.

For those having investments in bonds, whether directly or via mutual funds or variable annuities, this might be a good time to reassess one's exposure.

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Source: Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation 2013 Yearbook*, Tables A-7, B-6, C-1, and C-7