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Do bonds have a place in your portfolio?

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There has been much discussion about the future of the bond market in recent months – and rightfully so. Unprecedented intervention by the Federal Reserve has pushed interest rates and bond yields to record lows. And because rates are so low, the capital appreciation that usually results from declining interest rates is limited. Now, with the economy gradually improving, there is speculation that the Fed might start to unwind its current policy and raise rates. This puts bond investors at a difficult crossroads.

Historically, bonds have offered better downside protection, lower volatility and greater return certainty than stocks – unless there is a default, a bond can be held to maturity and the investor knows how much money to expect.

What You Should Know:

1. Why do interest rates matter?

Interest rates and bond prices are inversely related – when one increases, the other decreases. The prospect of rising interest rates is concerning to bond investors because, under such conditions, the value of bond portfolios will generally fall. However:

- How quickly rates might increase is an important factor – a more gradual increase could have a more muted impact.
- Because rates can remain stable for protracted periods or spike quickly, attempting to anticipate rate changes as your bond investment strategy can be both difficult and risky.

2. What is "total return" and why should you pay attention to it?

Total return looks at the price of a bond – what it will pay when it matures – plus changes in the interest income it generates. The relationship between these factors can mitigate the overall impact of rate changes on the value of a portfolio:

- The longer you hold a bond, the greater its potential sensitivity to interest rate change.
- Staggering durations in your portfolio can allow payments from lower-rate bonds to be reinvested in higher-rate vehicles and at least partially offset price declines.

3. Why should an investor hold bonds in a portfolio today?

Despite legitimate concerns about what might happen if, when and however quickly the Fed decides to unwind its current policies, there are still compelling reasons to include bonds in an asset allocation:

- Historically, bonds have offered better downside protection, lower volatility and greater return certainty than stocks – unless there is a default, a bond can be held to maturity and the investor knows how much money to expect.
- Bonds have also behaved differently than stocks under most conditions over the past 30 years, making them potentially valuable from a diversification standpoint when trying to manage volatility in a portfolio.
- Many bonds can provide a stable, predictable stream of income without the level of risk and potential for wide price swings found in other income-producing vehicles like dividend-paying stocks, although some bonds carry higher risks than others.

What you should do now:

At this point, you shouldn't be considering whether to exclude bonds from your portfolio but how much to allocate to them and how to position them. If you have significant bond holdings now or are questioning your asset allocation, we recommend you review the **latest white paper** from Baird's Private Wealth Management Research team, "Reframing Expectations: Recognizing the Challenges and Opportunities in Fixed Income," which can be found at rwbaird.com. Then schedule a conversation with your Baird Financial Advisor to talk about your specific situation and goals. ■

Past performance is not a guarantee of future results. There are many different types and characteristics of bonds, which should be evaluated carefully before investing.