The overlooked component of your retirement savings

Financial advisors often recommend that people should include a mix of stocks and bonds in their retirement accounts. Most people will find their stock investments have done well this year. At the time I write this, the S&P500 index is up 14.4 percent for the year. This index characterizes the investment performance of the largest 500 companies whose stocks trade on U.S. stock market exchanges.

In contrast, most people will find that their bond investments have performed poorly this year. For example, consider the largest bond fund, the Vanguard Total Bond Market Index Fund. This fund has over $160 billion in assets and is designed to match the performance of an aggregate bond index published by Bloomberg. At the time I write this, this Vanguard bond fund is down 0.98 percent for the year.

This negative return rate surprises people. They expect that bonds should be doing well since the interest rate is rising. Last year the yield on an investment grade corporate bond was 4.64 percent and currently it is 5.73 percent. Shouldn't bonds do better when interest rates rise? Well, no they shouldn't. At least not initially.

Here is why. Suppose that a year ago, an investment company bought a corporate bond for $10,000 that paid the owner $464 a year. You can think about this as an interest payment. I picked this payment because it would be the result of a 4.64 percent interest rate – the going rate a year ago.

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Then a year later, the interest rate increased to 5.73 percent. Investment companies can now buy a corporate bond for $10,000 that pays the owner $573 a year. So quite obviously, if an investment company can get $573 payments for $10,000, it will not pay $10,000 to buy the bond, only paying $464 like the bond issued a year ago did. And similarly, It will pay substantially less for the one-year-old bond now that the going interest rate has increased.

So you can see why bond funds have failed to do well recently. The bonds purchased when the interest rates were lower have become less valuable. A bond index fund that sells a bond purchased a year ago will take a loss on that transaction, which explains the low to negative returns that many bond funds have reported.

However, the higher interest rates are not all bad news for the bond markets. Quite the opposite. Eventually, the bond will mature, which means that the corporation that issued the bond will stop making payments (the $464 or $573 in our examples) and it will return the original $10,000 investment. Or the investment company holding the bond can sell it and take the loss. Either way, the investment company has money that it can invest in bonds that will earn a high interest rate. This high interest rate will increase the returns investors receive from holding bonds.

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For people holding bonds in their retirement accounts – which is most people – here is what you should expect. Initially, the higher interest rates will cause your bond funds to perform poorly. Then as time goes by and if the interest rate remains high, your bond funds will do well as the funds buy bonds that make high payments.

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