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How Not to Invest in the Bond Market

Investors poured billions into long-term U.S. government funds last year. Right on cue, the market tanked—again.

By Jason Zweig Follow

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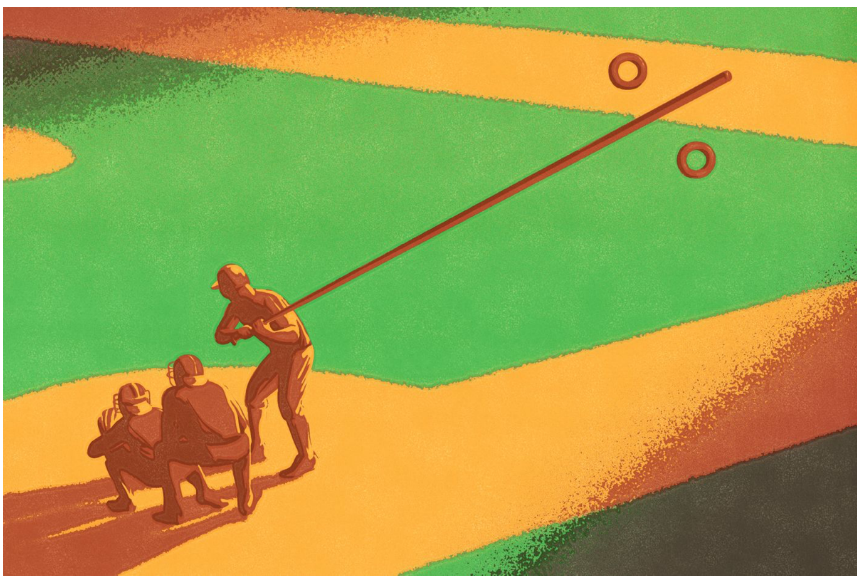


ILLUSTRATION: ALEX NABAUM

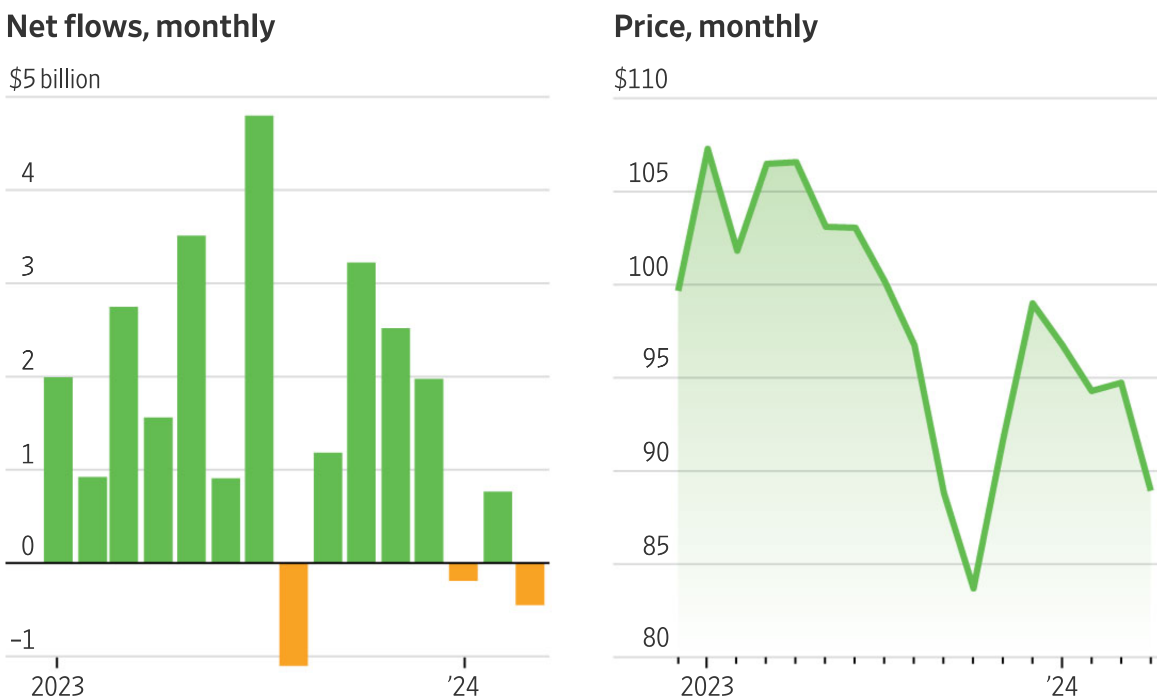
Only a few things in investing life are certain. One is that investors will always find a way to lose ungodly amounts of money on bond funds.

In 2023, investors poured a record $54 billion into mutual funds and exchange-traded funds specializing in long-term U.S. government debt, according to Morningstar. More than half of the iShares 20+ Year Treasury Bond ETF's $46.1 billion in total assets, for instance, came in during last year alone.

Right on cue, funds of Treasury bonds maturing in 20 years or beyond have lost about 9% so far this year, handing billions of dollars in losses to their latest buyers. Investors similarly shot themselves in the foot by loading up on bond funds in 1993 and 2014, right before the market tanked. You can avoid their fate, though, by following a few basic guidelines.

It's impossible to say for sure why so many people barged into long-term bond funds last year. Some, says Steve Laipply, global co-head of fixed-income ETFs at BlackRock, may just have been thinking, "Finally, I can get a yield in bonds that I haven't been able to get in years and years."

Chasing higher yields, investors poured billions of dollars into iShares 20+ Year Treasury Bond ETF in 2023—only to earn steep losses so far in 2024.



Sources: FactSet (price); iShares (flows)

U.S. Treasury securities are often called risk free, but they aren't—especially if you're buying funds that fluctuate every day even though their bonds won't mature for at least two decades.

If you predict that rates will fall and you turn out to be right, you'll hit a home run with long-term bonds. Hold individual Treasury bonds until they mature in 2044 or beyond, and you're guaranteed to earn the yield to maturity (about 4.8% this week), with no loss to principal. If you turn out to be wrong and rates rise, you'll still get all your principal back. (We're ignoring inflation here.)

As individual bonds approach maturity, they become less sensitive to changes in interest rates. That isn't the case with most bond funds, however; a long-term fund can remain volatile for as long as you own it. Depending on when you need to sell, that can be good or bad.

If you want to lock in almost a 5% yield for the next 20 years or more, you're probably better off with a long-term Treasury bond you can hold until maturity than with a long-term Treasury bond fund whose interim value will bounce around.

Whether you own a long-term bond or a long-term bond fund, you have to be ready to ride a roller coaster. At the biggest long-term Treasury funds, the duration, or sensitivity to changes in interest rates, ranges between roughly 15 and 16. That means an immediate one-percentage-point decline in rates would automatically raise the value of these funds by approximately 15% to 16%.

By the same token, a one-time, one-percentage-point rise in interest rates would knock about 15% or 16% off the funds' value. You'd incur an immediate $1,500 to $1,600 loss on a $10,000 investment—although, over time, the rise in rates would increase the income on the fund's bonds, enabling you to recoup some of that loss.

Long-term bond funds are so sensitive to changes in interest rates that even a 0.25-point move by the Fed will change the value of these funds by approximately 4%.

Because long-term bonds will produce the biggest gains if rates go down, they give you "more bang for your buck," says Laipply of iShares.

That doesn't mean you should use them to act on an interest-rate forecast.

Less than four months ago, Wall Street was convinced that the Federal Reserve would cut interest rates a half-dozen times in 2024. As recently as last month, the Fed itself signaled that it would likely cut rates three times this year.

This week, however, Fed Chairman Jerome Powell hinted that cutting rates might not be feasible anytime soon, given the robustness of the economy and the stubbornness of inflation.

Repeat after me: No one—not even the Fed!—can reliably forecast interest rates or the

Fed's actions.

You're kidding yourself if you think you can consistently make money by betting on what interest rates are going to do. And your financial advisers are kidding you if they say they are "positioning" your portfolio for a specific interest-rate scenario. If the Fed itself can't forecast rates, why would your financial advisers think they can?

Historically, the longer a bond's maturity, the more interest income it pays; that higher yield has compensated investors for the risk of locking up their money for longer.

This week, though, three-month Treasury bills yielded just under 5.4%, about 0.7 percentage points more than 30-year Treasurys. And intermediate Treasurys maturing in five and 10 years were yielding about 4.6%, barely less than the 30-year bond.

The upshot is that you can earn more on short-term than on long-term Treasurys. And intermediate-term debt—which historically has offered nearly all the return of long-term Treasurys at less risk—pays almost as well as the longest bonds.

So if you don't own a long-term bond fund, don't buy one.

If you do own one, brace yourself. The iShares 20+ Year Treasury Bond ETF lost 14% in the first 10 months of 2023. Then, in the final two months of last year, it gained 16.9%.

"There's going to be volatility with these funds," says Sam Martinez, head of bond index product for Vanguard. "Investors can use dollar-cost averaging to assuage the psychological strain of that volatility." That means reinvesting your interest income in the fund, or even buying more outright, to smooth the ride.

Better yet, take some of the risk out of your "risk-free" investments. Keep plenty of your money in Treasury bills and make an intermediate fund—or individual intermediate Treasurys—the heart of your fixed-income portfolio.

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