Answers to your questions about bonds

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On July 16, senior analysts Chris Philips and Fran Kinniry of the Vanguard Investment Strategy Group spent their lunch hour answering questions on Vanguard's Facebook page. Here are edited highlights of their conversation:

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Have Federal Reserve policies changed enough in the last few months to suggest that interest rates will rise more in the next four years than in the last four?

Fran Kinniry

Fran Kinniry: While investors certainly reacted to the Fed's recent communications, the fact is that Fed policies haven't changed that significantly and have been in line with expectations. The direction of interest rates over the next four years will be highly dependent on the traditional drivers—things like inflation, wage growth, employment, and strength of the U.S. economy, all of which are hard to predict.

What is Vanguard doing to protect its bond funds from the risk of rising interest rates?

Chris Philips: All bonds and bond funds are exposed to some degree of interest rate risk. Bonds with shorter durations have less exposure, but they come with lower expected returns. (The opposite is also true.) Because interest rate changes are notoriously difficult to predict, modifying a mutual fund's holdings based on interest rates assumptions is very challenging.

We've done research on fund managers' ability to take advantage of interest rate changes and have found that historically their performance generally failed to surpass the benchmarks they were tracking. Our white paper *The case for index-fund investing* shows some of our research on the topic.

What about bonds in target-date funds?

With target-date mutual funds serving as staples of many retirement accounts, some investors are wondering what will happen to the most conservative part of their portfolios —bonds—as interest rates rise. Vanguard experts acknowledge this concern but caution against overlooking the fact that these funds are designed to deliver for the long term.

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What can we do when bond fund yields are up and prices are down?

Fran Kinniry: As long as your asset allocation—the way your portfolio is divided between bonds, stocks, and cash—matches your goals, risk tolerance, and time horizon, we believe the best thing you can do is to stay the course. In fact, an important part of following a strategic asset allocation strategy is rebalancing to stay in line with your long-term plan, even when you may not want to do that because of changes in the market. If your bond prices are down and the stock market is up significantly—pushing your asset mix too heavily in equities' favor—then you might actually need to consider buying more bonds rather than selling them.

Can there be something like a "run" on bond funds?

Christopher Philips

Chris Philips: In a scenario like that, it's important to remember that for every seller, there needs to be a buyer. Over the past two months, the broad U.S. bond market lost approximately 3.5%, using the Barclays U.S. Aggregate Bond Index as a benchmark. Compare this to extreme events in the stock market. For example, from October 2007 to February 2009, U.S. stocks (represented by the MSCI US Broad Market Index) lost 55%. And despite the recent volatility in the bond market, there have been few if any reports of liquidity problems in the industry. For bonds, rising interest rates mean that (all else being equal) bonds are more attractive because higher yields attract new buyers, leading to greater liquidity.

Who benefits when interest rates increase and bond prices decrease?

Fran Kinniry: When interest rates rise, so do bond yields. As a result, investors with long time frames—those who don't expect to begin withdrawing from their accounts for many years—can stand to benefit from those higher yields. Thanks to the power of compounding, this can generally offset an initial price decline in a bond fund. All else being equal, this should result in a higher total return for long-term investors who stay the course.

I'm retired. What percentage of my portfolio should be in bonds?

Fran Kinniry: This is always a popular question. We believe your asset allocation should be based not on current market developments but on your specific goals, time frame, and risk tolerance. Vanguard's Target Retirement Fund series reflects how we think about asset allocation in general. They automatically become more conservative by expanding their bond allocations as the investor's target retirement date approaches. For example, if you're in retirement, Vanguard Target Retirement Income Fund has 70% allocated to bonds.

Are bonds better as a long-term or short-term investment?

Chris Philips: Bonds are generally used to offset the risks associated with stocks and other historically riskier assets. In most cases, riskier assets have been used to generate long-term growth. If your goal is growth but you think you may need to tap into your assets in the next year or so, it may be effective to look for both growth and income in a broadly diversified portfolio that includes both stocks and bonds. Within the bond asset class, short-term bonds are less likely to be volatile but may provide less potential return compared with longer-term bonds.

How will junk bonds react to rising interest rates?

Chris Philips: We've done some research on junk bonds and have found that they tend to react more to changes in the stock market than to the interest rate environment. This is because they're generally issued by companies that have lower credit ratings as a result of uncertainty surrounding their business.

As long as your asset allocation matches your goals, risk tolerance, and time horizon, "staying the course" may be your best option. If declining bond values and rising stock prices have pushed your asset mix too heavily in stocks' favor, you may need to consider buying more bonds.

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Notes:

- All investments, including a portfolio's current and future holdings, are subject to risk, including the loss of the money you invest.
- Bonds and bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.
- In a diversified portfolio, gains from some investments may help offset losses from others. However, diversification does not ensure a profit or protect against a loss.
- Past performance is no guarantee of future results.
- Investments in Target Retirement Funds are subject to the risks of their underlying funds. The year in the Fund name refers to the approximate year (the target date) when an investor in the Fund would retire and leave the work force. The Fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in the Target Retirement Fund is not guaranteed at any time, including on or after the target date.
- Please consult an independent tax or financial advisor for specific advice about your individual situation.

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