Why Invest in Bonds?

One of the major concepts of financial education is the importance of having bonds as a part of a personal financial portfolio.

Most people think that investing means buying stocks, but there are also many good reasons to include bonds as a significant portion of every savings nest egg. Especially as individuals approach retirement, a sizable portion of bonds should be included to fund those golden years.

Reason 1) The primary reason bonds are so important is their ability to preserve principal. Despite any price change in the bond market, if a bond is held to maturity, investment principal is paid back by the issuer. This is important – most people work hard for their money and would prefer to keep at least some of it safe from the ups and downs of the stock market!

Reason 2) Bonds provide stability. While stocks can have wild swings in price, bonds remain more consistent. Remember when the Dow Jones stock market index closed at 14,164.53 on October 9, 2007 and then promptly lost 54% of its value, falling to 6,547.05 on 3/9/2009? Volatility in bond prices, even in adverse interest rate environments, is seldom more than 20%. In addition, when stocks lose market value, usually bonds experience market price increase. So portfolios containing both investment types experience less overall volatility during turbulent economic times.

Reason 3) Bonds provide adequate and predictable income flow. While common dividends from stocks can be suspended and preferred dividends can be put in arrears, bond interest must be paid. In general, a diversified portfolio of bonds offers a higher yield than savings in banks, without substantially increasing risk.

In addition to these major reasons, investment grade bonds have extremely low default rates and in the rare case of default, bondholders have strong legal rights to both principal and interest payments.

So why don't more people place retirement funds in bonds or bond funds? The main reason people avoid bonds is they are hoping for something more exciting, like unlimited growth and long-term high returns. Think Google stock issued at $100 per share in 2004 and trading above $700 in 2007. Bonds just don't do that. You get your principal back and you get interest. Ho-hum!

But "ho-hum" becomes important as we near retirement. Retaining principal and experiencing good cash flow is so important that most experts agree: for the monies you need to make your retirement comfortable, over half of it should be in bond funds (short, medium, and long-term with inflation-protected bonds as a safe-guard against rising interest rates).

Should I invest in bonds? It's one of those frequently asked questions, and the answer is – YES. Bond investing should be part of every retirement portfolio (perhaps bond mutual funds for a simple way to enter that investment type), and it is especially suitable for senior citizens and savers.