

# Investment in bonds risky when rates rise

Government bonds are an asset that can be confusing to many, writes Noel Whittaker

THE 1929 stockmarket crash might have triggered the Great Depression that began in 1930 but it did not cause it.

The responsibility for that rested with governments everywhere who cut spending, slashed borrowings and erected trade protection barriers to protect local jobs.

Fortunately, governments today have learned from those mistakes and have tried to contain the current crisis by borrowing to pump liquidity back into the system to keep the economy moving.

Their efforts appear to have borne fruit because it seems that the worst is behind us.

However, the legacy is massive government debt, the effects of which will be felt for many years to come.

These borrowings have been financed by issuing trillions of dollars of bonds.

As a large proportion of these will end up being owned by the public either directly or through managed funds in superannuation, the new challenge for investors is to understand an asset class which has been ignored for many years.

On first glance, bonds are a very simple investment.

You buy a piece of government paper promising to pay you a fixed sum on maturity and interest at a set rate at regular intervals until that date.

For example, you can currently buy a Commonwealth government bond promising to pay you \$100,000 in April 2015, plus annual interest at 6.25 per cent paid half yearly until then.

It is a risk-free investment because repayment of both principal and interest is guaranteed by the Australian Government, and the investment is highly liquid because bonds are traded readily.

Sounds like the perfect investment, doesn't it? Risk-free and simple.

Well, remember the adage, if



GRIMMER TIMES: Governments might have helped cause the Great Depression in the 1930s but they have learnt a lot since then.

it seems too good to be true, it is. By buying that bond you have locked in the interest rate for the next six years, which means you could lose heavily if inflation hits hard causing interest rates to rise.

An interest rate of 6.25 per cent might sound great right now when all the bank will give you is around 4 per cent, and inflation is 2 per cent, but it would be a different scenario altogether if inflation went to 6 per cent and interest rates went to 10 per cent.

You would then be locked in to a fixed rate of 6.25 per cent which would mean that your real rate of return is just

0.25 per cent. You would get your \$100,000 back in April 2015 but it would only be worth \$70,000 in today's money.

Of course, because the investment is liquid, you could cash it at any stage before its maturity date. But then you would suffer a capital loss, as its value would be discounted to bring its fixed rate in line with current interest rates and also to compensate for the loss in purchasing power caused by inflation.

It would be different if rates and inflation dropped because you would find yourself holding a fixed rate government-guaranteed security paying

more than current market rates. You could then sell it for more than its face value.

Many people find bonds confusing because they fall in price as interest rates rise.

Therefore you might see headlines such as "Bond market in chaos as yields jump" and read that "bond prices fell as interest rates moved higher on inflationary fears".

Just remember that falling interest rates make fixed-interest securities more valuable - rising rates make them less valuable.

Also keep in mind that short-term bonds, such as three years, are a less-risky

investment than longer-term bonds such as 10-year bonds.

This is because the period that the rate is fixed is much shorter, and because there can be less inflationary erosion of capital on maturity as the timeframe is much shorter.

Summing up, bonds can be a great investment in times of falling interest rates and low inflation, but can be extremely risky at a time of rising rates and high inflation.

Historically, they have not performed as well as shares.

For the five years ended July 2009 the Australian bond index returned just 6.43 per annum, whereas the All

Ordinaries Accumulation index returned 8 per cent per annum.

Naturally, you should seek advice as to what is best for your own situation but, for me, quality Australian shares will beat bonds every time as long as you are prepared to hang in when the inevitable downturns occur.

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