

Think Purchasing Government Bonds is Risk Free? Think Again.



As a general rule, to earn higher returns you have to take greater risks; conversely, the least risky investments offer the lowest returns. The bond market is no exception to this rule. The average returns from bond investments have historically been lower, though generally more stable, than average stock market returns. Bonds are considered to be less risky than stocks for several reasons:

- Bonds carry a promise from their issuer to return the face value of the security to the holder at maturity; stocks offer no such promise.

- Most bonds pay investors a fixed rate of interest income promised by the issuer. Stocks sometimes pay dividends, but their issuers have no obligation to make these payments to shareholders.
- Historically the bond market has been less vulnerable to price swings or volatility than the stock market.

Yes, government bonds guarantee the redemption of par value. But if you're socking away your hard-earned money, ideally it should grow. Unfortunately government bonds aren't going to give you much in return for your initial investment. And bonds aren't exactly risk-free. Let's go over some of the risks associated with bonds so you can be a better informed investor and you can get the most out of your money.

First of all, there are losses. Interest rate risk can make a long-term bond less profitable. When interest rates rise the prices of fixed-rate bonds fall; when rates decline, bond prices increase. If a bond has a long time to go before its maturity, its interest rate risk will be greater. If you buy bonds at a high level and interest rates increase, your bond prices go down – that is an investment loss.

There are also risks associated with the effect of inflation. Basically, due to inflation, tomorrow's dollar will be worth less than today's, so the purchasing power of a bond investor's future interest payments and principal is reduced. Inflation occurs when there

is more money to be spent on goods. As a result prices rise. For example, if a government chooses to restore its economy with a stimulus package, more money will enter the system and usually interest rates then rise. That's bad news for bond holders because, as stated above, when interest rates go up, bond prices go down. Inflation also affects the final return on a bond. The real return is diminished by inflation and the inflation rate is 3.9% compounded annually. Think about what that means for your investment.

You also have market sentiment to contend with. Market sentiment is the combined feeling of all market participants. Some traders might feel it is a bull market and others might feel it is a bear market, and they will trade accordingly. But the majority opinion determines the direction of the market. There is a risk that the bond market as a whole could decline, which would bring down the value of individual securities no matter what their fundamental characteristics are. In recent market downturns even bond funds dropped significantly.

But perhaps the greatest loss suffered from purchasing bonds is the loss of opportunity costs. When a buyer chooses to keep his money locked up in bonds he incurs unrealized losses and misses opportunities for higher returns. He ends up losing in the long-term. So if you're looking for a risk-free investment, purchase 90 day treasury bills which are held in money markets. But understand that they offer negligible yields. For the best return on your investments, speak to a qualified financial advisor and create a balanced portfolio with his or her expertise. Because storing all of your money in "risk-free" investments simply isn't worth the loss.