Bond risks and how bond funds deal with them

Where's the risk?

A bond is a promise. In return for money lent to a corporate or governmental borrower, the borrower pledges to make periodic payments of interest at a fixed rate and to repay the original loan after a set period of time. Both the date at which the principal is scheduled for return and the time remaining to that date are known as the bond's "maturity."

When a person buys a bond at its issue, holds it to maturity, and the issuer keeps its promises, there *is* no risk.

Most bonds, however are not treated that way. Bonds are issued by all kinds of companies and agencies, held in large portfolios—including thousands of mutual funds—and traded in markets around the world. Bond risk arises from the workings of these markets. It comes in two principal forms.

Credit risk

Credit risk refers to the financial soundness of the issuer. Will it be able to make interest payments and return one's principal on schedule? Credit risk varies from issuer to issuer, with U.S. Treasury securities at the top of the scale and high-yield "junk" bonds at the bottom. The more speculative the bond, the higher the yield required to attract investors.

Bond funds must state clearly what kind of bonds they hold, including the credit ratings acceptable in their portfolios. Funds lessen the impact of repayment problems on the part of any issuer by holding a large number of bonds from different issuers.

Interest-rate risk

Interest-rate, or market, risk refers to the sensitivity of bond prices to changing market conditions. Bond values move in the opposite direction from prevailing interest rates.

To see why, suppose that you own a 5% Treasury bond with a face value of $10,000 and a ten-year maturity. If the government is issuing new ten-year bonds paying 6%, investors won't pay $10,000 to earn the $250 every six months that you're getting when they can earn $300 for the same investment. So you would have to accept less—specifically, the amount that will make your $250 payment equal to a 6% yield to maturity: $9,256.

Of course, when interest rates fall, your bond *gains* in value. At 4%, for example, your bond would carry a price tag of $10,818.

Funds manage their exposure to interest-rate risk by controlling the average maturity of bonds in their portfolio. The more time remaining to maturity, the more a bond's value will be affected by a given change in interest rates. We know that, at ten years' maturity, a 5% bond gains $818 in value with a 1% drop in interest rates and loses $744 with a 1% rise. At 30 years the comparable figures would be a gain of $1,738 or a loss of $1,384.

Evaluating a fund

Bond funds run the gamut from very safe to quite risky. It's important to know what you're getting into when you invest—whether the fund you're considering invests in government or corporate bonds and, if corporate, what credit ratings it demands. If the fund invests in foreign bonds, you'll also have to contend with fluctuating currency values.

Remember that your total return will consist of capital gains or losses as well as interest income. A short-term fund with maturities between one and three years will limit your change in value, but generally offers lower returns. A money market fund invests only in very short-term debt securities and attempts to maintain a stable net asset value. Intermediate funds with maturities from four to seven years provide a compromise between risk and potential return.