Understanding Risk for Bond Investors

A primary reason investors own bonds is for the income received from their interest payments. So should you own bonds when interest rates are low? The answer is a definite … maybe.

That ambivalence is because another big reason for holding bonds is their values have historically remained relatively stable over time. In other words, they've been less risky than stocks (of course, their returns have been lower as well).

So even when interest rates are low, you might want to have bonds in your portfolio because when the stock market takes a hit, the bonds could stabilize your portfolio's overall value. And that may help you avoid making emotional (and sometimes costly) heat-of-the-moment choices.

Lower risk doesn't mean no risk

Bonds are considered less risky than stocks, but they're certainly not risk-free (no investment is). Although some investors may believe bonds are as safe as cash, that's not the case. In fact, bond investors face a number of risks, including:

Interest rate risk. The chance of a change in a bond's price in response to movements in interest rates. It's important to understand this risk in a low-interest-rate environment because bond market prices and interest rates are negatively correlated. In other words, if interest rates increase, existing bond prices are likely to decrease. Conversely, when rates are higher and begin to decrease, bond prices will tend to increase.

Credit risk. The prospect that an issuer may suffer a relative decline in credit quality or outright default. The lower the credit risk, the fewer credit-related price fluctuations there should be.

Default risk. When you purchase a bond, you face the risk that the issuer may be unable to pay the interest or par value when it's due.

Opportunity risk. The possibility of missing out on potentially better returns you may be able to get from other investments, like stocks.

Consider your big picture

Whether you're talking about bonds or stocks or any other investment, it's important to remember that the amount you own should be determined based on a strategic asset allocation — how your portfolio is divvied up between different investment types — based on your:

- **Goals.** What you're investing for, such as being able to afford retirement.
- **Time horizon.** How long you have before you need to tap into our investments. If you're 48 and want to retire at 68, you have a 20-year time horizon.

- **Risk tolerance.** How comfortable you are with fluctuations in your portfolio's value. If market volatility makes it difficult for you to get a good night's sleep, you likely have a relatively low risk tolerance.

If you already invest in bonds or are wondering whether you should, you need to understand their risks and the important role they can play in your overall investment strategy. For help with that, you may want to work with a professional financial advisor.

Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can cause a bond's price to fall. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

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