Investor Insights & Outlook

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Investing in Bond Funds

If you don't want to invest all your assets in the stock market, you may need to consider either cash or bonds for your portfolio. While cash is relatively safe, returns are likely to be less than 1% given the low interest-rate environment. Bond funds are an alternative but most people don't have a good understanding of what to expect. You may want to consider buying a bond fund to give your portfolio stability or help generate income. Unlike individual bonds, bond funds hold a number of fixed-income securities with varying maturities. Therefore, investing in a bond fund provides a diversification benefit. In order to save yourself from making costly mistakes, it helps to thoroughly check up on what a bond fund owns before you buy in. Two basic determinants of bond performance are interest-rate sensitivity and credit quality.

Interest-rate sensitivity is important because an inverse relationship exists between bond prices and yields. If interest rates fall, bond prices rise, and vice versa. The credit quality tells you how risky the bond fund is, which can help determine if the fund fits your risk profile. Consider these factors before you go bond-fund shopping. Just as you wouldn't want to have all of your stocks in one style, you also want to diversify your bond portfolio. A well-rounded bond portfolio should have some exposure to most of the following bond types: Government, mortgage-backed, municipal, corporate, and world bonds. It is important to understand that the right combination of bond funds ultimately depends on your investment goals and risk profile.

Diversification does not ensure a profit or protect against a loss in a declining market.

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A Primer on Hedge Funds

Hedge funds are investment vehicles that started to gain recognition in the late 1980s and experienced significant growth in the 1990s. They are "funds" in the sense that their managers pool money from investors and invest it, but their investment strategies are quite different from those of traditional mutual funds. Differences can be found in four major areas: regulation and legal status, investment strategies, performance evaluation, and fees. Mutual funds are strictly regulated by law. They are required to register with the Securities and Exchange Commission (SEC), the United States' official regulatory agency. Mutual funds have to publish a legal document called a prospectus, stating the investment objective of the fund, its strategy, risks, historical performance, fees, expenses and other information. Most mutual funds are widely available for purchase and will accept a large number of investors.

In contrast, hedge funds are not subject to the strict regulations that apply to mutual funds. Hedge funds are not required to register with the SEC, they are not legally required to publicly disclose performance and fee information, and their fees tend to be much larger than those charged by mutual funds. Hedge funds are available only to a limited number of "qualified" (read: "rich") investors, meaning investors with assets in the million-dollar range.

Hedge funds implement what are called alternative investment strategies (as opposed to traditional ones), such as short selling, risk arbitrage, global macro, managed futures, distressed investing, and discretionary trading. We will not describe these strategies in detail here, but the idea is that hedge funds are much more flexible than traditional mutual funds in what their managers do with investments. For example, a traditional investor would buy stock X and hope it goes up in value. If a hedge fund manager had reason to believe stock X would drop in value, he or she would take action in the marketplace accordingly. This is called selling short, a popular hedge fund strategy—not something a regular investor would do.

Hedge funds also differ from mutual funds in the way they measure return. Mutual funds normally look at return relative to the market. For example, you hear that fund X has beaten the market by 4.3% in 2012. Hedge funds tend to look at absolute, as opposed to relative, return: they strive to earn a certain return each year (let's say, 20%), regardless of how the market performs. Hedge fund advocates argue that absolute return is a better performance metric. If a mutual fund manager lost only 6% in a year when the market went down by 12%, he or she would be rewarded for "good" performance. If the fund manager made 20% in a year when the market grew by 30%, that would be qualified as poor performance. Not so with hedge funds. Measuring absolute return prevents this type of error—either you made money or you didn't.

Similar to mutual funds, hedge funds charge an annual management fee calculated as a percentage of total assets. This fee is required regardless of the profitability of the fund. In addition to the management fee (and unlike mutual funds), hedge funds also charge a performance fee. A hedge fund manager can retain a certain percentage of all gains in the fund above a certain rate, which is known as the "hurdle rate." For example, let's say a fund met its hurdle rate of 10% (had a 10% return), and made $1 million on top of that. The manager is allowed to keep his or her incentive fee of (normally) 20%—$200,000.

This information is provided for illustrative purposes only and should not be viewed as a recommendation to buy or sell the type of investment noted above. Please note that hedge funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. In addition, hedge funds are not required to provide periodic pricing or valuation information to investors, involve complex tax structures, often charge high fees, and can be highly illiquid.

Assessing Risk

Investing and poker have been compared on many levels. For starters, poker is a zero-sum game—what the winner wins has to be equal to what the losers lose. But investing is not a zero-sum game because over time stocks tend to have positive returns, making it possible for investors to be overall winners.

Both, however, are games of incomplete information with unknown variables and conditions that cannot be controlled. To offset these uncertainties, it is important for players of both groups to assess and understand their appetite for risk. Doing so develops discipline, a strategy, and may help reduce unexpected setbacks.

The questions below are designed to help shed light on your risk tolerance. The questions are hypothetical in nature and are not meant to represent investment advice. Answers are symbolic of different risk levels: "a" conservative, "b" moderate, and "c" aggressive.

1. I am comfortable with investments that may often experience large declines in value if there is a potential for higher return.

a. Disagree b. Uncertain c. Agree

2. Suppose you owned a well-diversified portfolio that fell by 20% over a short period of time. Assuming you have 10 years until you begin withdrawals from your account, how would you react?

a. I would immediately change to a more conservative portfolio. b. I would wait at least 6 months to one year before changing to more conservative options. c. I would not change my portfolio.

3. Which statement best describes your investment goals?

a. Protect the value of my account by minimizing loss and accepting lower long-term returns. b. Balance moderate levels of risk with moderate levels of returns. c. Maximize long term returns and accept large or dramatic swings in the value of my investments.

4. Portfolios with the highest average returns also tend to have the highest chance of short-term losses. The data below represents five hypothetical investments of $100,000 over a one-year time frame. Which range would you feel most comfortable with?

a. Portfolio A: $139,000 – $88,800 b. Portfolio B: $179,000 – $75,700 c. Portfolio C: $215,000 – $59,500

Now, keep in mind that these are only guidelines meant to give you insight into how you think and behave as an investor. Once you have discovered that you are, let's say, aggressive, this certainly doesn't mean that you now have to invest in high-risk stocks and emerging markets for the rest of your life. On the contrary, your risk tolerance may change over time, and revisiting these questions pereiodically may let you know if it's time to change your investment strategy.

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

Bond Basics

Benefits of investing in bonds: Potential for growth, historically lower risk, diversification and income are some of the benefits of investing in bonds. Generally, bonds have provided investors with growth and historically demonstrated less volatility than stocks. Because economic events that decrease stock prices tend to increase bond prices, and vice versa, adding bonds to a portfolio can provide diversification benefits. Bond investors generally receive income at fixed intervals that can be used to offset cash obligations or increase portfolio liquidity.

Bonds and interest rates: There exists an inverse relationship between bond prices and yields. If interest rates fall, bond prices rise and vice versa. Suppose an investor purchases a 20-year $1,000 bond with a yield of 8% and interest payable annually. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for the original price of $1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower interest or coupon payments (10% – 8% = 2% less per year in interest payments).

Diversification does not ensure a profit or protect against a loss in a declining market. Bonds are subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

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