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Bonds Aren't as Safe as You Think

If interest rates rise, they'll plummet in value, forcing investors to sell at a loss or stay trapped for years.

By Steven Grey

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Investment risk has never been more challenging to gauge. Before last week's market decline, it would have been almost laughable to suggest that investors should stay on the sidelines. After all, the S&P 500 gained 30% in 2019—despite trade tensions and slow growth overseas. And then the floor dropped out from under the stock market.

Because the subsequent flight to safer investments bolstered bonds generally, some may say my concern is overblown. Fixed-income investors will likely continue to mistake relative price stability for safety. Quantitative easing naturally cultivated this complacency.

By imposing QE and forcing interest rates to basement levels, the central bankers have effectively reduced the yield curve to a ladder with all the middle rungs ripped out. The monetary authorities deliberately deprived investors of the decent returns they could once achieve with bonds offering modest yields at reasonable risk. Frustrated and in need of income, many investors have essentially surrendered, taking on more risk than they should because they see no alternatives. Their only options have been either to take on too much credit risk by lending to dubious borrowers or assume excessive interest-rate risk by owning too many ostensibly safe bonds that will plummet in value in the event that interest rates escalate.

Investors have been willing to reach for yield primarily because they have been conditioned to believe that bonds are inherently safer than most alternatives, including equities. But what if that isn't necessarily the case? Much of the risk comes down to price, and quantitative easing has inflated bond prices to the point that many are downright dangerous.

When we talk about interest-rate risk, we're actually talking about duration—how sensitive a bond's price is to changes in interest rates. When rates rise, bond prices fall because what they pay (the yield) has to compete with newer bonds being issued at higher interest rates. Depending on how sensitive a bond is to interest rates, it can decline a lot. Duration on the Bloomberg Barclays Global Aggregate Treasuries Index just hit a record 8.6 years—which means that every 1% increase in average yield would trigger a price decline of around 8.6%.

Are the yields investors receive today even remotely sufficient to offset the losses that will occur in the event that interest rates suddenly spike upward? In many cases, no. Of course, investors can avoid actually realizing a loss by simply holding the bond until it matures. If it's a solid credit, they'll receive 100% of their money back.

But if it doesn't mature for many years, they could be trapped in that bond for a long time. If in the meantime interest rates rise significantly (they hit the midteens during the Reagan presidency), the opportunity cost for investors will be gigantic. Imagine being locked into a bond paying 3% for years when you could be receiving 12%. If interest rates surge, the only way for investors owning long-maturity bonds to escape those low returns would be to sell and accept a huge loss on what they had considered a very safe investment. The results for many could be disastrous.

In reaching for yield, investors can also attempt to capture a higher return by assuming more credit risk. But they're probably underestimating the downside in that category as well. In 2018 Moody's Investors Service lowered its estimated average recovery in the event of default by more than 20%, from the historical average of 77 cents on the dollar to 61 cents. Compare that with the current yield for the high-yield index of 5.5% at time of publication. Does that seem like an attractive return, given the potential risk? By the way, the corporate bond index as I write yields just under 2.5%, which means that investors are receiving only about 3% additional yield for investing in junk bonds rather than blue-chip corporates. That's a pretty small consolation for such a drop in quality. Note that about 30% of B-rated issuers default in a typical recession, versus fewer than 5% of investment-grade issuers. So expect most investors sweeping up low-grade loans to suffer if the economy takes a plunge.

With so much reward-free risk coursing through the markets, where should investors turn? It's not the message many want to hear, but right now the best option is simply to stay off that ladder. Don't reach for yield. Whether it's further out in the calendar or lower in credit quality, the incremental yield most likely doesn't come close to compensating you for the risks you're assuming.

If keeping a large amount of your cash in liquid, low-yielding investments seems less than appealing, there's one very important consolation: When the market finally does reprice to more rational levels, you'll be in a position to put that money to work and earn fabulous returns. Nothing is more valuable or conducive to future profits than having cash when most others don't. It's the investment advantage that eclipses all others.

"Fear of missing out" exerts a powerful pull, but not a rational one. Don't take the bait and reach for yield. If counting the losses you'll avoid doesn't help you sleep better at night, dream of how much you'll make when prices have plummeted.

Mr. Grey is CEO and chief investment officer of Grey Value Management LLC.