Financial Planning

Bonds for Wealth

Many advisors—and investors—think of bonds as perfect income generators, but nothing is perfect.

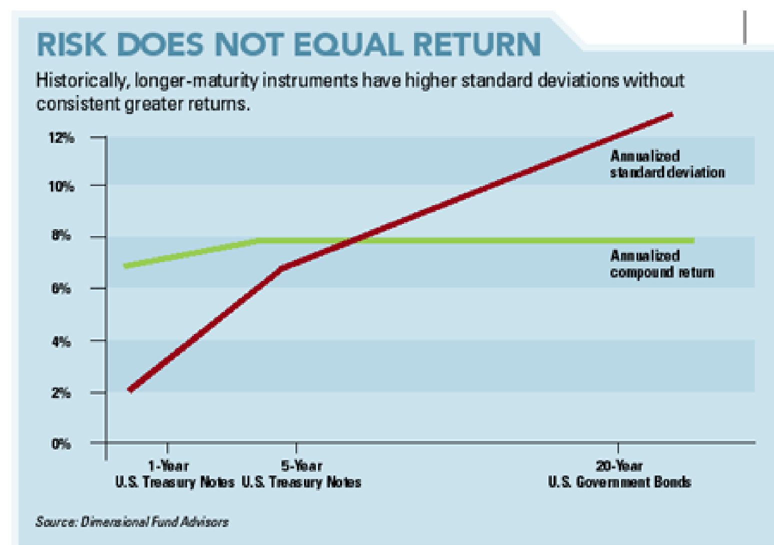
By Gene Fama Jr.

July 1, 2007- Advisors and their clients often use bonds to meet current and future income needs. This is especially true when it comes to building portfolios for retirees who need steady cash in lieu of a paycheck. But while bonds can be a steady source of income, using them expressly for that purpose can add risks advisors didn't plan on.

Using bonds to meet future cash needs or generate income differs from the more traditional asset allocation approach, where bonds diversify a portfolio and reduce overall risk. In the former approach, bonds are often seen as a de facto insurance policy that "immunizes" retirement goals from investment risk. Fixed income covers ongoing bills and frees up the rest of a portfolio to pursue growth through riskier instruments. If the riskier stuff doesn't pan out, the thinking goes, your clients will still have their bond income to support them in high style. If the riskier stuff wins big, they might not even need the bonds. Either way they win, right?

Unfortunately, the raw pursuit of income can engage inadvertent risks that can be especially rough on retirees. And for what? In the end, financial security is about total wealth, not marginal income. Still, emotional insecurities are rife, especially for investors cashing their last paycheck. Some much-needed perspective can help sidestep pitfalls.

Getting enough cash out of bonds to completely fund cash flow needs often means extending bond maturities or going lower in credit quality. This increases yield—and risk. Historically, the market value of longer-term bonds has been more volatile (as measured by standard deviation) than that of shorter-term bonds-without much added return to show for it. (See "Risk Does Not Equal Return," below.)



It's not entirely clear why this is the case. It may be because institutional investors, such as insurance companies, use long-term bonds to meet future obligations like employee pensions. Thanks to actuarial tables they have a pretty good idea of the size and timing of their payouts, so they simply match the duration of their bonds to these dates. When the bonds mature, the proceeds pay off the obligations. In this limited framework, volatility along the way doesn't matter. Therefore, the way long-term bonds are priced may not be determined mainly by volatility but by factors related to the liability streams of big market players.

It's just a theory, of course. What we do know is that institutions use bonds precisely in this way, and that it might even make sense—for them. When an employee retires, his or her pension benefit is typically not adjusted for inflation. It's a nominal liability to the plan, which

can be met with a nominal bond. If the retiree is youngish, the liability is longer in term—so the plan buys a longer-term nominal bond. As long as the plan isn't among the handful that includes cost of living adjustments, inflation is all but irrelevant.

Contrast this with a typical client saving for retirement. The client's "liability" stream is his or her future consumption—which is highly sensitive to inflation. A long-term bond is a lousy way to hedge this liability because it tends to tank with unexpected inflation, right along with the client's spending power. An individual might be better off with a bond that moves up and down with inflation, such as a short-term nominal bond or an inflation-protected TIP. These instruments, however, don't throw off as much cash income.

Think Big

The bonds that generate the most income are lower in credit quality, longer in maturity or both. They're also historically riskier, without a lot of additional return to compensate. Portfolio theory teaches that, for any two portfolios with a roughly equivalent average return, the one with lower variance will generate the higher terminal wealth. The relevant goal for individuals is therefore to maximize return for a given level of volatility. Like it or not, bonds aren't surgical tools applied to a specific purpose. They are components of an entire plan. To treat them as dedicated income can undermine the plan's goals, if not the very tenets of portfolio theory.

One reason to maximize return for risk is that funding needs in retirement are not as predictable as you might think. Individuals aren't insurance companies—they don't know their future liabilities with great certainty. Life expectancy, healthcare and other costs can change drastically and clients might need more money than their dividend income provides. Unless you're a big pension plan, it makes sense to hold high-quality, short-term bonds with maturities that vary according to changes in the yield curve. This approach focuses on expected return instead of income, with a record of lower standard deviation than longer bonds. Plus, short-term bonds seem to offer better inflation protection, a crucial benefit for individual investors.

This leaves the question of where income will come from absent hefty bond yields. The answer lies in work of Nobel laureates Merton Miller and Franco Modigilani, who taught us that return is return, whether it's from dividends or capital growth. One way to meet monthly cash needs might be simply to redeem assets from the portfolio. This approach—a "synthetic dividend"—can also help manage taxes and costs. If you redeem instruments held for longer than a year, the cash receipts are taxed at the capital gains rate of 15%, instead of higher dividend income tax rates. You can also plan redemptions to rebalance a portfolio, selling shares of whatever investment is overfunded relative to its target weight. Or you can sell investments with embedded losses and thereby offset taxable gains elsewhere in the portfolio. Viewing the portfolio as a whole offers opportunity to add value as an advisor.

I realize that drawing cash from investment principal instead of income can be tough to swallow. But this might be a case where basic portfolio theory gives us the discipline to beat back emotion and do something that makes genuine sense. In the end, the form of your cash receipt is less important than the size of your wealth. Investors can draw cash from a higher-yielding strategy and take extra risk that might not pay off, or they can reduce bond risk and redirect the saved risk to equities, where the average returns are better.

I'm not advocating that you load up on stocks for retired or older clients. To the contrary, because retirees depend on their investments more they should be deployed more conservatively—which is why a portfolio of short-term, high-quality bonds and a focus on a strong tradeoff between risk and return are rules to retire by.

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