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When are Bonds Too Risky?

By Gil Hanoch, July 7, 2005

In the previous article, "[When are Stocks Too Risky?](#)" (Hanoch, June 2005), you learned about the various risks of stocks and a way to use them without taking excessive risks. In this article you will learn about the various risks of bonds, and the ways bonds can be used without taking excessive risks. Let's start by answering the question asked in the title:

When are bonds too risky? There are many risky ways to invest in bonds – many more than we would like to admit.

1. **Bonds as a long-term investment (including retirement)** cannot effectively build your financial security. They provide low returns that result in minimal income after adjusting for inflation. The risk is not losing the dollar value of your investments, but outliving your retirement. When compared with carefully constructed stock investments described in the article mentioned above, bonds are too risky.
2. **Bonds cannot save us in case of an unprecedented global catastrophe.** Historically bonds, as well as stocks, recovered from all declines and made up for the whole decline period. If you are losing sleep over the possibility of your stock investments being wiped out by a global catastrophe, you should know that bonds might not save you either. Most companies would be devastated and the government would lose its ability to tax people in order to repay its loans – bonds will lose their value.
3. Any **bond that is not backed by the government** can lose significant value up to 100% in cases where the company that borrows your money fails and declares bankruptcy. This risk applies to all companies with no exception.
4. Any **bond not held to maturity** can drop in value if interest rates go up, in order to make up for its lower return compared to new bonds.
5. Any **long-term bond** has returns that are fixed for many years. If interest rates go up, the real returns of the bond go down. In certain cases, you might even lose purchasing power even if you hold your bonds to their maturity!

The first point above states that bonds cannot provide good long-term security. No matter what bond investment you choose, a carefully constructed stock portfolio (globally diversified, no stock selection or market timing and low costs) provides better long-term security that increases exponentially over the years.

What about short-term financial security? We know that stocks can be highly speculative in the short-term, making them useless for short-term security. Let's find out whether bonds can be used to provide this security.

When are bonds safe enough? There is one case in which bonds can be safe enough: high-grade bonds, with a short maturity that are used solely to provide short-term security. All of these conditions must be true together, so I will detail each of them individually:

1. High-grade (backed by the government with a limited amount of diversified corporate bonds)
2. Short to intermediate maturity
3. Only used for short-term security

These bonds tend to have limited fluctuations, making them ideal for short-term financial security. If you expect to use a large portion of your savings within the next few years, and there is no way you could delay the expense, you should not use stocks. A severe recession could leave you with a lot less in savings than you thought you had. When holding bonds, you are “paying for insurance” in the form of lower returns than company ownership (stocks), in order to know that the money will be there for you.

Are there alternatives to bonds that are better? There are many other alternatives to bonds for short-term security, including: checking, savings and money market accounts. All of these alternatives are either loans to the banks holding your money, or an aggregation of bonds and other short-term loans. They all offer lower returns with lower volatility, making them also viable for short-term security.

To summarize

Bonds are very important for maintaining short-term security. When using high-grade, short-term bonds you are likely to preserve your short-term security for the following reasons:

1. Most of them are backed by the ability of the government to collect taxes, vastly decreasing the risk of default.
2. Their short maturity makes them less affected by changes in interest rates.
3. Their low returns are not a problem if their usage is limited to short-term needs, while leaving the long-term security to stocks.

No one guarantees that bonds will always provide perfect short-term security, but sticking to the ones mentioned above makes them likely to do so.

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