Is $4 Trillion at Risk in Bond Funds?

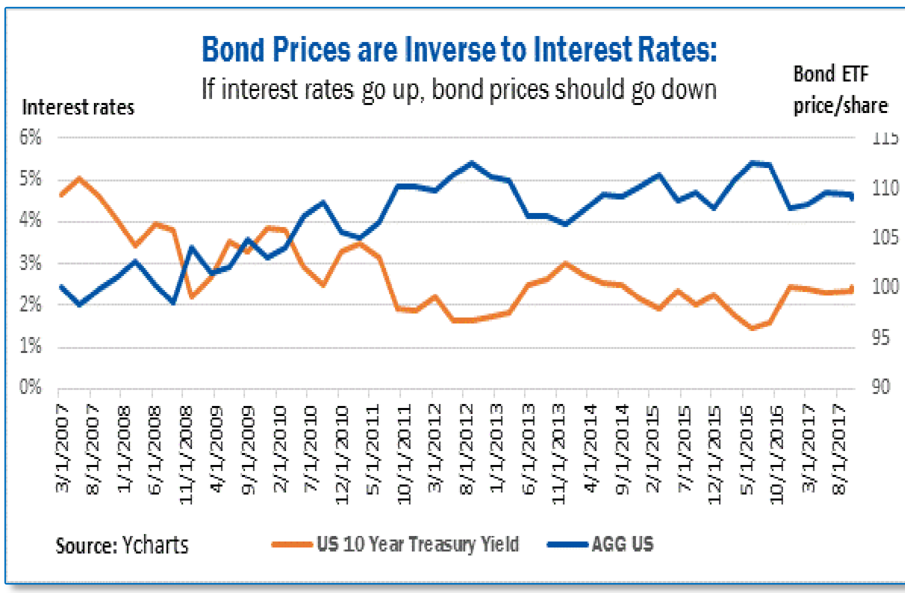
All Americans with Savings Need to Understand Bond Fund Risk

By Maya Marisa Joelson
President, Meta Point Advisors
Registered Financial Advisor, Harvard MPA, Kellogg MBA

What you think are your safest investments might actually be your riskiest. Most financial advisors and robo-advisors have yet to notice, let alone adapt their recommendations to this reality.

More than $4 trillion in U.S. bond funds stand to lose value as interest rates continue to rise. Bond funds are 22% of the $18.9 trillion market of US mutual fund and ETF assets as of year-end 2016[1].

Bond funds are offered in 98% of company-sponsored 401(k) retirement plans[2]. Most robo-advisors and professional money managers are relying on bond funds for their "conservative allocations" in clients' portfolios. Every American with an investment account at a financial institution needs to understand the risks inherent in bond funds.



All things being equal, bond math dictates that when interest rates rise, bond prices will fall. This is because when interest rates rise, new bonds are issued offering better rates than what previously issued bonds provide. Thus, existing bonds which were issued at lower rates lose value.

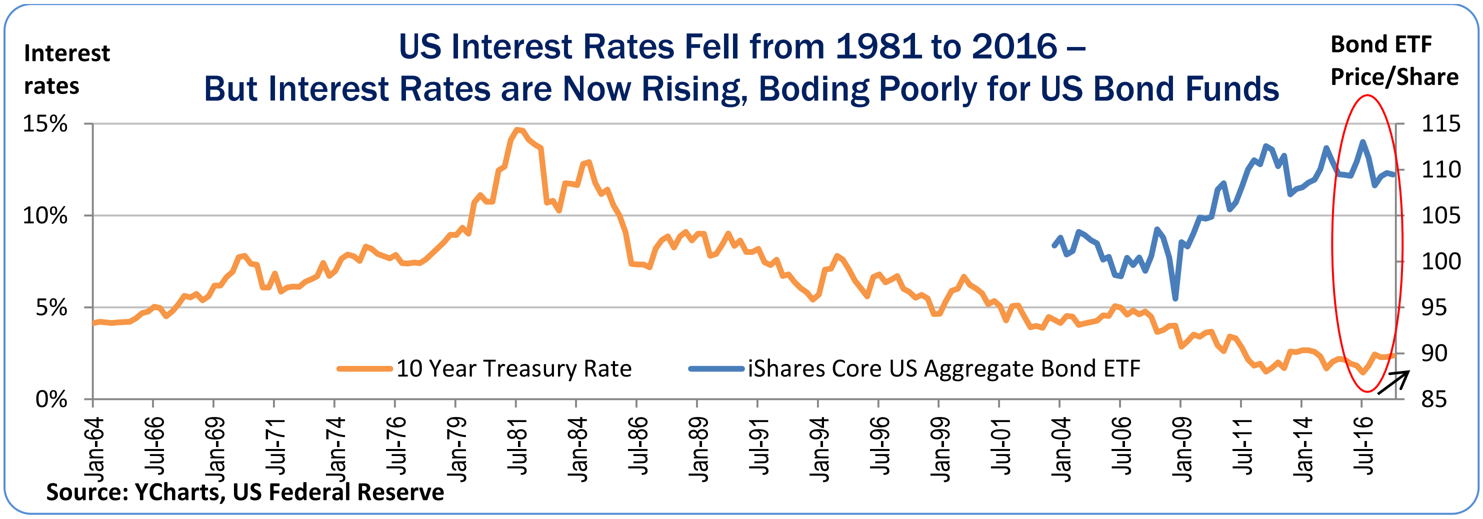
Therefore, the value of US bonds in bond funds should decline when US interest rates go up. This is true for Treasury, corporate, and municipal bond funds which are all valued as a spread to the US Federal Reserve's "risk-free" interest rates.

You might think of bond funds as similar to individual bonds which are known to be conservative investments – but bond funds can be much riskier. A bond owner has a legal contract that they will receive the promised interest payments and the principal back at maturity, even if the market price of the bond falls. Bond fund owners may believe their investment is even safer than owning an individual bond because they are diversified -- but bond fund owners have no legal rights to principal repayment.

Bond funds deprive you of the benefits of owning individual bonds: stable, predictable income and a high degree of confidence that you will get your initial investment back.

When you buy a bond fund, you are buying a synthetic product. The 2008 crash was caused by the unwinding of the massive investment in synthetic products (related to collateralized mortgage and debt obligations). Since then, there has been massive investment in bond funds and many bond fund investors don't understand the underlying risks of these synthetic products.

This risk is evident from recent history. At the end of 2016, bond funds lost 4% in value just from a quarter of a percent rate increase. The chart below shows the effect, with the largest US Bond fund iShares AGG based on the Barclay's U.S. Aggregate Bond Index[A], the benchmark for U.S. bond funds, declined 4%.



Hypothetically, for the owners of $4 trillion in bond funds in the US, this equates to $160 billion in unrealized losses. In a rising interest rate environment, bond funds are at risk of losing money and NOT conserving principal.

Worryingly, the bond funds that sound the safest actually can perform the worst. The iShares 20+ year Treasury bond ETF (TLT) lost -6.7% in the 12 months ending September 30[3]. This is the opposite of what happens when you buy longer duration bonds outside of funds: normally yields are set to reward you the most when you loan money for the greatest number of years. Emerging market bond funds like the iShares J.P. Morgan USD Emerging Markets Bond ETF have performed best in part because they are not as correlated to US interest rates. Of course in all cases, past performance is no guarantee of future results.

Attracted by easy execution and cheap fees, and accelerated by the Department of Labor Fiduciary rule, US investors keep pouring money into bond funds. Net inflows into bond mutual funds in 2016 was $107 billion while another $85 billion flooded into bond fund exchange traded funds (ETFs), a 24% surge in this sub-asset class[4]. Normally surging inflows into an asset class would drive up the valuations, but the bond fund benchmark gained only 0.25% in 2016, less than most advisory fees.

Bond ETFs are only 15 years old -- too young to have been stress tested. During their short lifespans, the Federal Reserve interest rate has gone from 5.2% to zero and is just starting to creep back up. Incoming Fed Chair Jerome Powell stated in his confirmation hearing that, "we expect interest rates to rise somewhat further" and that the, "case for a December rate hike is coming together."[4]

Bond ETFs have only existed in an era of declining rates and increasing asset flows. In contrast to equity funds, the US bond market is much more illiquid and bond trading has become more infrequent since 2008. Therefore, it may be hard for the bond funds to get good prices for bonds if they need to sell to

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honor redemptions, which could magnify losses.
Bond mutual funds may fare better than bond ETFs because the bond managers can reserve cash and actively prepare for redemptions.
Interest rates are at an inflection point, and looking at historical returns can be deceptive. Yet some financial advisors and robo-advisors rely on those historical returns to advise their clients.

A Bond Fund Bubble?

Former Fed Chair Alan Greenspan has warned of a potential bond bubble, but hasn't mentioned that bond fund holders may be the most vulnerable as they do not have the protections of bond holders.

Moreover, the rapid increase of bond funds to $4 trillion may have created a systemic risk unto itself.

Finally, while institutional investors may understand the current risks in the bond market, most retirees and individual investors probably do not understand the risk they are taking with these investments which their financial institutions are calling "conservative" investments. If the bond market does crash, individual investors may fare the worse.

The impact of rising rates has been tempered by both the gradual pace of the rate hikes and geopolitical events such as Brexit, which made U.S. bonds an attractive alternative. Low to negative yields in Japan and Europe also translate into demand for US bonds. Bonds traditionally were used to provide stable, predictable income; but in our view, bond funds have become just another speculative asset class, akin to equities. In the case of bond funds, investors are speculating on inflation, the dollar, and relative rates. Yet the risks of owning bond funds may outweigh the potential gains going forward.

Bond funds made more sense from 1980 to 2012, when net asset values rose in response to the downward trend in interest rates. However, even Vanguard writes that the bond ETF market has many more complications and less liquidity than the equity ETF market[7]. As rates rise, we should expect capital loss, not capital gain. Bond funds may experience more net outflows than they can properly handle.

It is time for investors to review their portfolios and retirement options with an eye towards these risks. Those that heed the warnings and adjust now should have no problem extricating themselves from bond funds at a decent price. Those that are well informed will be in a better position to extricate themselves from bond funds if they determine this is in their best interest.

All employees at American firms should review their 401(k) options and selections. If bond funds are being offered as the “conservative” choice, they should bring up the risk to their management and plan

Bond Risks in Retirement and College 529 Target Date Funds

Those who have entrusted their money with Target Date Retirement Funds and 529 Target Date College Funds could be particularly vulnerable to bond fund risk. Investments in target date and lifestyle funds increased 18% in 2016 to $1.1 trillion dollars, according to the 2017 Investment Company Factbook. Vanguard is the most popular provider and their website states the 2020 fund is comprised of 44% bond funds[5]. Those closest to retirement have the largest bond fund risk.

Likewise, investments in college savings 529 plans hit a record in 2016 with $275 billion[6]. The average 2021 plan is composed of 46% bonds according to savingforcollege.com.

administrators. International and unconstrained funds managed by active managers may provide better options to passive US ETFs.

For those assets outside your current employer, you can roll over your 401(k) to an IRA and shift your assets to a financial advisor who can provide you with alternatives to bond funds. Find an advisor who understands the risks of bond funds and who can navigate today's rising rate environment with investments that have the potential to beat inflation yet have downside protection.

ENDNOTES

1. 2017 Investment Company Factbook. 57th Edition. www.icafactbook.org. According to Investment Company Factbook 2017, there are $4.08153 trillion in bond funds in the U.S., comprised of $3035.83 billion in taxable bond funds, $613.7 billion municipal bond funds, and $432 billion in bond ETFs (pp. 69 and 172).
2. 2017 Investment Company Factbook. 57th Edition. www.icafactbook.org. p.8.
3. www.ishares.com. https://www.ishares.com/us/products/etf-product-list#!type=ishares&tab=performance&view=grouped&fac=43515&subtab=navQuarterly
4. Powell, Jerome. "Fed Governor Jerome Powell Offers Testimony for Confirmation Hearing. November 27,2017.
5. Vanguard Target Retirement 2020 Fund (VTWNX). Portfolio and Management. Asset allocation as of 09/30/2017.
6. Kozlowski, Rob. "529 Plan Assets Record 8.6% Gain in 2016". Pensions & Investments. March 21, 2017.
7. Thomas, Chuck. "Fixed Income ETFs: A bond investment living in an equity market world." Vanguard ETF Perspectives. Fall 2017.

A. Per Wikipedia, many index funds and exchange-traded funds attempt to replicate (before fees and expenses) the performance of the Bloomberg Barclays US Aggregate Bond Index. The index includes Treasury securities, investment grade corporate bonds, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S. www.wikipedia.com

Marisa (Maya) Joelson **maya@metapointadvisors**
Founder of Meta Point Advisors *415-691-1062*

Maya is a Harvard-trained economist who leverages her two decades of top-level experience across Wall Street, the City of London, emerging markets, and advanced technology to devise investment strategies for her clients. She founded Meta Point Advisors after several years as a Financial Advisor at Merrill Lynch. Maya's clients benefit from her ability to provide savvy active management without the cumbersome costs and structure of mutual funds.

Maya's ability to abstract important concepts or "Meta Points" has differentiated her, whether writing about Russia's conversion to capitalism while at Harvard, women in business at the World Economic Forum, equity markets in London's hedge fund community, or artificial intelligence technologies for DARPA program managers. She seeks to leverage these insights to achieve superior outcomes for her clients.

Maya Marisa Joelson holds a MPA from Harvard Kennedy School, a MBA from Kellogg at Northwestern University, and a BA from Wesleyan University.

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