Financial Planning

PORTFOLIO

4 Big Myths About Bonds

By **Allan S. Roth**
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Like nearly all financial planners, I have a portion of my clients' portfolios in bonds, bond funds or other fixed-income investments, such as certificates of deposits. In the process, I spend quite a bit of time educating clients to think differently about these types of assets.

Part of the secret to doing bonds right is debunking four commonly accepted bond myths.

MYTH 1: THE PURPOSE OF FIXED INCOME IS TO PRODUCE INCOME.

It seems logical that fixed-income investments produce income to live on, but is it really true? I keep hearing that rates are so low today that savers are being punished and borrowers rewarded. I would argue that the truth lies in doing the math.

To see why this is a myth, we must first keep in mind the purpose of our clients' portfolios. They worked hard, lived below their means and converted human capital to investment capital. That investment capital is essentially stored energy to give them freedom to do what they want for the rest of their lives. I tell clients that their goal shouldn't be to die the richest person in the graveyard, meaning they can and should spend the principal.

Now on to why fixed income seldom produces income. Thinking back to 1980, CDs and U.S. Treasury bonds produced a handsome 12% interest rate. A $1 million portfolio seemingly produced an income stream of $120,000. Reminding my clients of those times typically brings a nostalgic smile and a longing for the supposed good old days.

There is less smiling when I remind them that taxes ate up a third of their income, and they got to keep only about $80,000, or 8%. Finally, the smile is completely wiped away when I point out that inflation averaged 13% back then. According to my calculations, this part of their portfolio actually lost about 4.6% of its spending power. Measured against the purpose of the portfolio, the returns of