Episode #209: Bond vs Indexed Annuity: Where to Allocate as Interest Rates Rise

Video Transcription

Welcome back to "Money Script Monday." My name is Kyle. We're going to hop right into it today, and I'm going to lead off with a question for you: In a low historical interest rate environment, does it make sense to own bonds or bond funds as an asset class to reduce portfolio risk?

As of recording this episode, the 10-year Treasury bond is yielding 1.38%, which is near the historical bottom. Knowing that eventually interest rates will begin to rise, when they do, existing bonds can experience significant losses. To answer my question, the point of this episode is to show you to reduce that bond exposure and to provide an alternative to a bond when interest rates start to rise. If we look on over to the board here, the status quo or the traditional way of balancing a portfolio in retirement comes down to two components: stocks and bonds.

You ask 50 different financial advisors out there, and there'll be a certain arrangement between these two; they're doing that to manage that client's risk versus return appetite and hedge against stock market volatility. But as we know, does that always make sense? While it is a tried-and-true strategy over the last hundreds of years in an increasing interest rate environment, it doesn't make sense. Our theory believes that it does not because if we look at the bond market and we learn about how it works, it's based on supply and demand.

When there's volatility in the market, that creates demand for protection, for bonds, for preservation, with some form of return. When you have so much demand relative to the low supply of bonds, what you're going to experience are new yields or interest rates going down which then increases the value of existing bond prices.

A good representation to show you that strategy is to look at the 10-year treasury from 1954 to this year, 2021. What you'll notice is the apex in the middle at the peak in 1981, we saw interest rates up until yesterday; if you owned bonds during that 30, 40-year bond bull run, you would've been a happy camper.

But the question for you is: where do you think interest rates will be going from here? Will they be the same? Will they be lower? Will they be higher? It doesn't take a rocket scientist to show you that, knowing interest rates move in 30-year cycles, interest rates are going to be going up.

If we look at the two core dangers to owning bonds, the first is credit risk. In other words, will the company be there to pay off its debt? A lot of people don't have to worry about that because advisors suggest investment-grade bonds that only that have high creditworthiness. But the companies and the municipalities that don't have high creditworthiness typically can attract investors with higher yields to offset that default risk.

The bigger concern, the bigger risk for you, is to look at interest rate risk. The longer that bond maturity is, the bigger this risk is because the relationship between interest rates and bonds is inverse. What does that mean? When interest rates go up, bond prices drive down. Vice versa, when interest rates go down, bond prices go up.

In this example, if you owned an existing bond that was paying a 2% coupon at face value at $1,000, a year later, a similar corporation with the same creditworthiness issues a new bond at 3%. Well, your existing bond at 2% becomes less attractive, becomes less worthy. What happens to the price? It gets driven down at $666. If you were to sell it, you would take a loss. If you held it to maturity, you wouldn't have to worry about that because you'd get your principal back. But as you can see, that's a big risk here as interest rates start to climb.

Where am I getting at? Kyle, are you saying to go to the stock market? Are you saying invest in risk-free government bonds where I can barely get any interest? What I'm suggesting is not to replace your bond component; what I am suggesting is reducing your overall exposure. We're going to reduce that exposure and carve off some of those assets for what we call a fixed indexed annuity contract that's issued and backed by an insurance company, all of which are going to accomplish the same goals a bond would.

It's going to give you that steady 3% to 5% yield, potentially more. It's going to provide you capital protection, so your principal is always 100% secured. And it's going to give you some options for a lifetime income. I put liquidity on here because it may not be the most liquid asset, so you want to make sure that you have enough assets on the sidelines for those emergency-type needs.

When we look at our recommended balance, you'll notice it's not too different from what the status quo is today. All we're doing is reducing that bond component, increasing our fixed indexed annuity, and keeping that stock position the same. Now you might ask, and I don't blame you, "How would this theory, how would this strategy have worked during a time when interest rates started to grow?" And we've done that. We looked in the year 1954 up until 1981 when interest rates went...and it began to increase, eventually peaked in 1981, and we found 3 things:

What we found is that the fixed indexed annuity is going to improve your overall risk-adjusted return, it's going to reduce your negative effects of rising interest rates, and it's going to eliminate outright overall downside risk that you'd experience from the market.

I know we spoke a lot about annuities, the dangers, and alternatives. I'm going to ask you that same question that I opened with: in a low historical interest rate environment, does it still make sense to own bonds and/or bond funds to reduce overall portfolio risk?

If you have any questions, reach out to the financial advisor that shared this video. Have a great day. Thanks again for tuning in.