Bonds: Not risk-free

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Are they poised for a fall? Investors buy bonds for safety. Compared to the stock market, the backing of, for instance, the U.S. Treasury or a blue-chip firm when buying a bond feels like pulling into a safe port in the stormy seas. Yet bonds aren't without risk, a fact that many investors overlook. A bond carries credit risk, meaning that the issuer could default. It also carries inflation risk. If inflation expectations rise, notes The Washington Post, the rate of interest on new bonds will increase and the price of already-issued bonds will fall. A weakened U.S. dollar, suggests Minnesota-based advisor and physician Joel Greenwald, MD, CFP, could act as a catalyst to strengthen American producers-- and pick up inflation.

You also have to contend with reinvestment risk, notes Pennsylvania-based bond expert Stan Richelson. You might have earned 6% on a bond that recently matured, but now-- with interest rates so low-- you may earn only a 3% return if you reinvest the proceeds for the same term. Coming collapse? Today, the risk in bonds might be greater than it's been for many years, suggests the Post. Currently, we're in the greatest bond bull market in modern history, with bond yields falling and bond prices rising almost every year for the past two decades. But, suggests the Post, in a statement that might send chills through your spine, "The sudden enthusiasm of small investors for bonds today could be just as dangerous as their sudden enthusiasm for tech stocks in the late 1990s." The current climate in bonds reminds Greenwald exactly of the tech bubble. The risk of interest rates rising (and bonds decreasing in value) is greater than the risk they'll fall, he says. Without the current crowd mentality rushing to bonds, investors might understand that they're at a high point in price and a low point in yield, suggests New York investment advisor Steven Abernathy. No one should confuse safety of principal with owning bonds, he says.

Risk reduction

That's not to say you should eliminate bonds from your portfolio. The shorter your investing time horizon, the more you need "period-certain" investments, such as bonds, says Abernathy. Still, take steps like these to reduce your risk:

- Use short-term bonds. Abernathy would stay in bonds with terms from 1 to 3-1/2 years. Don't, he suggests, bet against the Federal Reserve if it chooses to reinflate the economy.

- Use bond ladders. Buy bonds at different terms. This adds flexibility to your bond portfolio.

- Avoid bond mutual funds. They can lose value, says Greenwald. These funds, notes Richelson, never come due, as would individual bonds. If interest rates rise, the fund's value could decline and stay down indefinitely, he suggests.

- Consider Treasury-Inflation Protection Securities (TIPS). These can help protect against inflation.

Contrarian views In February, we told how Richelson advises some of his clients to put their entire portfolio in bonds. Especially with a potential for deflation in the economy, you should take steps to protect your principal at all costs, he says, instead of reaching for a little more yield. This avowed contrarian questions the assertion that over time, stocks will always rise in value.

Going that far out on the limb isn't for everyone. But it reflects the need to carefully plan how bonds fit into your financial plan.