Investing in bonds the safer option, but there are still risks

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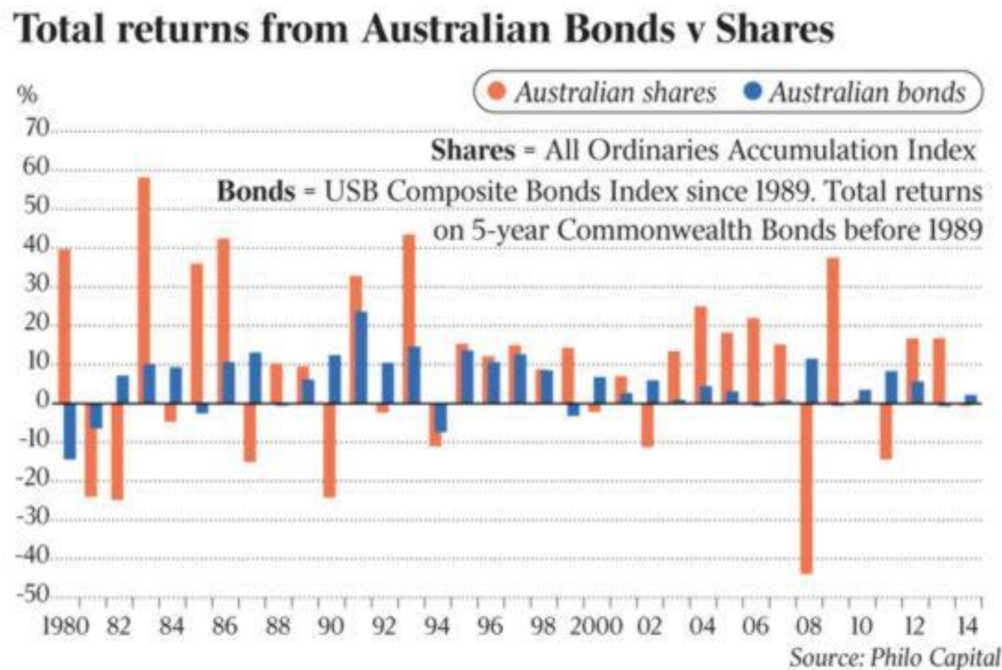

BONDS tend to stabilise investment returns when sharemarkets are moving strongly up or down. In the last 20 to 30 years, they have performed this counterbalancing role while also rewarding investors with an average return almost as high as shares. Alas, average investment returns are likely to be more subdued in the next decade or two, especially from bonds.

Today's chart shows real returns, pre-tax, from Australian shares and bonds by calendar year since 1980 (for 2014, the six months to June).

Bonds particularly helped to stabilise overall portfolio returns when shares slumped in 1982 and 1990-91 (recessions), 2008 (global financial crisis) and 2011 (market fears of US double dip and China slowing).

The major exception was 1994, when bond investors anticipated a sharp acceleration in inflation; the panic that resulted caused big losses on holdings of both bonds and shares.

If we revert to how many investors look at returns — before inflation is taken out — Australian bonds have, since 1980, delivered an average return of 9.3 per cent a year.

That’s not much below the 11.8 per cent a year average annual return from shares — and bond returns have been much less volatile.

The spectacular returns on bonds in recent decades owe a lot to yields having been unusually high in the early 1980s and early 1990s (on 10-year government bonds, the yield was about 12 per cent in 1980 and 10 per cent in 1990).

Since those years, bond yields have mainly trended down. Ten-year government bonds have recently traded with a yield of 3.4 per cent.

As an asset class, bonds are lower risk than shares, but they can’t be seen as risk-free. Over the centuries, many governments have seriously defaulted. Australian investors holding government bonds in 1931 had interest payments cut and repayments of principal delayed.

(A fascinating account, by Ashley Owen, of that oft-neglected episode was recently published in Cuffelinks.) In my view, there’s close to zero risk of another default on bonds issued by our federal or state governments.

Default will be experienced on some issues of Australian corporate bonds. But bond investors, including those holding Australian government bonds, face other risks.

Inflation erodes — and unexpected rapid inflation devastates — the purchasing power of most government bonds (those where interest payments and the repayment of principal are set when the bonds are first issued).

Here and abroad, government bond yields are currently not much higher than rates of inflation (and many are below inflation). In my view, demand for inflation-linked bonds and floating rate securities will increase sharply in the next couple of years as investors prepare for a cyclical rebound in global inflation.

Another risk to investors is of bond prices falling as market yields rise. (As market yields go up, investors choosing to sell some or all of their bonds have to accept lower prices to attract would-be buyers. This affects the stated value of all bonds priced on a “mark to market basis).

To illustrate, were the yield on a 10-year bond issued by the Australian government to jump by half a percentage point from its unusually low recent level of 3.4 per cent — perhaps because moods in the US bond market were souring — that government bond would drop in price by about 2.25 per cent.

Sensible diversification across shares and bonds is always an important principle of good investment — but what’s sensible diversification varies across the investment cycle.

Average yields on shares, and particularly bonds, are unlikely to be as high in the next decade as they’ve been in the last quarter-century or so. As a result, expect a growing role for absolute return funds.

And government bonds aren't risk-free.

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