

Bonds in a Taxable Portfolio

June 24, 2024

One reasonable way to estimate the investment return on a bond is simply to use the current yield on that bond. If the bond sells at par or \$100, the yield is merely the bond coupon. If the bond is trading in the secondary market at either a discount or a premium, then there is a calculation called yield to maturity (the date when you get your principal back) that looks at the difference between the current price and the projected price of the bond at maturity. Bonds selling in the secondary market should experience a price change when interest rates fluctuate. For example, if interest rates went from 3% to 4%, a bond issued at par in the prior 3% interest rate environment must fall in price to compete with the higher-yielding 4% bonds if the bond is to be sold.

Over the past 44 years, we've witnessed a significant drop in bond yields. U.S. government bonds, known for their safety, saw their yield on a thirty-year bond peak at over 15% in 1981. However, following the 2008 financial crisis, newly issued thirty-year government bonds plummeted to below 3%. Currently, the yield hovers around 4.5%. For an investor planning to hold this bond for thirty years, the yield could be 4.5%, assuming reinvestment of dividends at the same yield. However, if interest rates fluctuate, the return on a yield-to-maturity basis could be higher or lower.

For taxable investors, that 4.5% may not be a sufficient reward for giving up the use of funds for thirty years. First, interest payments are taxed at ordinary income tax rates, which are higher than capital gains tax rates incurred when stock investments are sold at a gain. Combining state and federal income taxes, that 4.5% yield could be reduced to 2.5% or lower. Second, the expiration of the Trump tax cuts in 2025 could increase taxes, further lowering the attractiveness of bonds. Third, the effect of inflation is expected to run between 2-3%, bringing the real return on those bonds to zero! A higher inflation rate not only impacts the value of the interest on the bond, but inflation also reduces the actual value of the principal value of the bond. Lastly, if an investor decides to diversify fixed-income investments by purchasing a mutual fund or exchange-traded fund, there is the additional expense of the management fees on the fund, further lowering the rate of return. On the other hand, the fund approach offers the prospective benefit of increasing income from the fund if interest rates go higher and the fund invests new money in higher-yielding bonds. If interest rates fall, then the value of the fund should increase.

The traditional mix of a diversified portfolio is 60% stocks and 40% bonds. In an environment of rising interest rates, it's advisable to hold more bonds, while in a declining interest rate environment, the opposite is true. However, the allocation to bonds in a portfolio should ultimately be based on the taxable investor's personal financial circumstances and risk tolerance, taking into account the potential impact of interest rates, taxes, and inflation on bond yields.