BUSINESS

Road to Retirement: Should investors avoid bonds?

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April 4, 2021 at 6:00 a.m.

If you are fan of Warren Buffett, you may have seen his most recent opinion about investing in bonds. In his annual shareholder letter, he basically said if you own them, you face a bleak financial future. But bonds are a part of almost all prudent asset allocation strategies. I'm sure you've heard of the traditional 60% stock and 40% bond allocation for retirement plans. For over 100 years, this has served as a sound way of managing money. You take a reasonable amount of risk with stocks but balance it with a healthy dose of more stable bonds.

If bonds have been popular with investors, why is Buffett so down on bonds? Before recent history, bonds used to represent one of the best ways to modestly grow your wealth without taking much risk. With a bond, you receive a guaranteed interest rate for the term of the bond. And if the entity issuing the bond is financially healthy, you get your money back when the bond matures. For instance, you could invest $1,000 for 10 years at 6% in a government bond. That means you collect 6% a year and get your $1,000 back when it matures, very similar to how a CD works at a bank.

Photograph by Ellen Jaskol

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Sounds like a good deal, so what's the problem? The problem is the interest rate. Currently, interest rates are below the rate of inflation and it's likely they will stay there for a long time. If your interest rate is below the rate of inflation, then you are losing wealth (purchasing power) every year you hold money in bonds.

Let's compare the "old" bonds to today's "new" bonds. In the year 2000, if you invested in a 20-year U.S. Treasury bond, your interest rate would have been about 6.5% for the next 20 years. Even better, the inflation rate was only a little over 2% for that entire period. That means you were earning about 4% above inflation every year and increasing your wealth in terms of purchasing power.

But today, if you buy a new 20-year U.S. Treasury bond, your interest payment is about 2%. So unless inflation runs below 2% for the next 20 years, you will be losing purchasing power. That means whatever part of your portfolio you hold in bonds is likely "dead money" in terms of its ability to build wealth for retirement.

Even if inflation runs at 1%, your return above inflation would only be 1%. That's a lot less than the 4% excess return investors received who bought bonds 20 years ago. That means you face two bad outcomes. Either you will lose purchasing power every year because inflation runs above 2% or you'll barely be moving ahead if inflation runs below 2%. And since the Federal Reserve is trying to create inflation, the first scenario is the more likely one.

That's why Warren Buffet thinks the future is bleak for bond investors. Now you might be wondering if you should scrap all your bond holdings. The answer is a bit more nuanced.

First, Buffett made that comment about investments you intend to hold for the long term, meaning 10 to 20 years or more. If you think you will need cash in the next five to seven years, you'll still need to hold money in high-quality bonds or cash reserves. It's really the only way to ensure the money will be there when you need it.

Second, you have to know your own risk tolerance — meaning if you don't hold any bonds and only hold stocks, can you handle seeing your wealth decline by 50% or more for an extended period of time. Buffett is worth about $98 billion, so if his wealth falls by 50%, he can still afford a hamburger. But the rest of us don't have that luxury. Most of us probably need a certain level of stability in our portfolios regardless of the fact that we may not earn much on that money over the long term.

There is no "right" asset allocation between stocks and bonds that works for everyone. The "right" one is the one you can stick with through good and bad markets. You'll need to decide that for yourself. But because bonds will make it hard to accumulate wealth over the long term, It's probably best to lean toward the riskier end of your personal risk tolerance. By that, I mean having as little in bonds as you can tolerate.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.