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Can Bonds Disrupt Your Retirement?

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We've all heard that it is wise to make our portfolios more conservative as we approach retirement. Historically, it's been recommended that we decrease equity exposure and increase the amount of bonds in our portfolio, but is that really the wisest thing to do given today's low interest rate environment?

Let's have a deeper look The Rule of 100 is a popular recommendation that financial advisors have pitched for a long time. This rule indicates that you should consider your age when designing your asset allocation inside your portfolio.[1] The rule states that if you are 60 years old, you should have about 60% of your portfolio invested in bonds and the other 40% invested in stocks. Ten, 20, even 30 years ago, when most financial advisors were cutting their teeth, this was actually pretty good advice. But, back then, interest rates were much higher than they are today; remember those 16% interest rates you used to get in the banks?[2] Interest rates have been falling over time, which means that the value of bonds sold on the secondary market have been going up.[2]

It's important to understand how the value of bonds fluctuates on the open market. To illustrate this point, let's imagine that newly issued bonds sell for $1,000 and pay a fixed interest rate. If a bond issued this year is worth $1,000 and pays 3% interest, what happens to the value of that bond if next year's newly issued bond (also selling for $1,000) is crediting 2% interest? The value of your bond crediting 3% goes up because someone would likely give you a little more money for your bond yielding the higher rate than the newer bond offering a lower rate. By the same token, what if the opposite happens? What if next year, newly issued bonds are paying 4% interest? In that scenario, nobody in their right mind would give you $1,000 for your bond that's only paying 3%! So, the value of your 3% bond would now be less than $1,000. You have lost principal!

When you think about today's interest rate environment, which is near all-time lows, and the Federal Reserve declaring that they will raise interest rates, what do you think will happen to the value of your bonds over time?[3] That's right: They'll go down. And isn't that a recipe for disaster when the Rule of 100 has you putting a significant portion of your portfolio into this losing proposition? At the time of this writing, the aggregate bond index is down about 3% year to date. So what can you do for a safer, more reliable alternative to bonds?[4]

Investors preparing for or already in retirement are flocking to fixed indexed annuities and using them as a bond replacement. So, in our Rule of 100 example of a 60-year-old formerly placing 60% in bonds, they're now utilizing fixed indexed annuities to cover the portion of the secure money investments in their portfolio.

Fixed indexed annuities allow the investor to participate in a portion of the upside in equity markets while incurring none of the downside risk typically associated with investing in equities. For example, some fixed indexed annuities will allow you to participate in 50% of the S&P S00's growth each year, and the insurance company issuing the fixed indexed annuity will absorb all the risk during the down years. There are usually a variety of market-linked indexes one could choose from to help diversify the growth opportunities of their fixed indexed annuity.

Seem too good to be true? What's the catch? First, there's a time commitment to a fixed indexed annuity, typically about 7-10 years for the richest contracts. So, if you want to take all your money out before the surrender-charge period, then the company can penalize you for not staying the length of the term. Next, there's limited liquidity, typically about 10% per year that you could take out of the investment without any penalty from the company. Additionally, the company can change the crediting method, if they want to, throughout the course of the contract; but, historically, changes have been tied to interest rates: The higher the interest rates go, the higher your participation in the growth can be.

There are no fees in most fixed indexed annuities. There can be a cost, however, if an income rider is selected. An income rider is an option that provides a guaranteed income for the remainder of your life, even if the cash value runs out in the policy. The lifetime income rider in many fixed indexed annuities can provide a single lifetime guaranteed income or a joint lifetime guaranteed income if the client is married and would like the income to continue should one spouse predecease the other. In some fixed indexed annuities with an income rider, one can also gain access to additional income should they be unable to perform two out of six of the activities of daily living. It can be an attractive option for those who do not currently have any costly long-term care insurance policies because there is no medical underwriting in a fixed indexed annuity's application process.

One should always consider both the pros and cons when looking at any investment, which is why it is important to work with a fiduciary financial advisor who has your best interest at heart while helping you create your customized portfolio.

[1-4] For sourcing and more information, please visit https://www.forbes.com/sites/impactpartners/2018/10/02/can-bonds-disrupt-your-retirement/#5832ecc56ef6.

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