The cost of waiting — bond investments

Wealth Management

Among the many decisions facing investors, determining when to invest funds is one which frequently causes anxiety. While market timing is often attempted, it is a risky undertaking, particularly when it comes to the bond market.

Many investors delay their purchase of bonds because they think interest rates are going to rise. In the meantime, they keep funds in lower-yielding savings and money market accounts. What they may not realize is that even if interest rates go up to a level where they are ready to purchase bonds, the higher yield may not make up for the lower return received while they were waiting. It is difficult to make up this penalty imposed by the "cost of waiting."

The cost of waiting can be best illustrated with an example. Let's compare Investor A, who buys a bond with a $100,000 par value that matures in ten years and yields 3.0%, to Investor B, who will not buy the same bond now because he thinks that interest rates will go up. Investor B, therefore, keeps his money in a money market account currently earning a 0.2% yield. If interest rates do not change and he continues to wait in the money market, Investor B will earn $2,000 over the course of ten years. Investor A would earn $30,000 in that same time period. Furthermore, even if there is an annual 50 basis points increase in the money markets over those nine years, the additional income would not be comparable to investing in the 10-year bond. In fact, Investor B would still be earning $5,500 less than Investor A.

Playing catch up

There are many different scenarios one could consider. The following examines one that could transpire if the Fed were to remain on hold for the next two years, then ratchet up rates quickly due to rapid economic growth, before moving to a holding pattern to assess the impact of their actions. Investor B earns the low 0.2% money market rate for two years, then sees that rate increase 100 bps per year for three years before leveling off for the final five years. Even in this scenario, it would take

Scenario 1: Interest 3% 100m face	Money market @ 0.2%	Total difference accumulating over life	Scenario 2: Increasing money market rate of 50 bps/ year for next nine years	Total difference accumulating over life	Scenario 3: Money market stays the same for two years, then increases by 100 bps/year for three years, then stays constant	Total difference
3,000	200	-2,800	200	-2,800	200	-2,800
3,000	200	-5,600	700	-5,100	200	-5,600
3,000	200	-8,400	1,200	-6,900	1,200	-7,400
3,000	200	-11,200	1,700	-8,200	2,200	-8,200
3,000	200	-14000	2,200	-9,000	3,200	-8,000
3,000	200	-16,800	2,700	-9,300	3,200	-7,800
3,000	200	-19,600	3,200	-9,100	3,200	-7,600
3,000	200	-22,400	3,700	-8,400	3,200	-7,400
3,000	200	-25,200	4,200	-7,200	3,200	-7,200
3,000	200	-28,000	4,700	-5,500	3,200	-7,000

For illustrative purposes only

Investor B until the fifth year to begin to turn the tide, and still have earned $7,000 less than Investor A by the end of the term. There are always many moving parts within the bond market, so the more known things (3% coupon, 10 years) the better to help take the volatility out of the market.

Count the cost

We do not have a crystal ball to see when rates are going to rise and how much, but we do know that putting money to work is key.

Trying to time the market can be costly. If you are concerned that interest rates might rise, there are better strategies you can employ than to "wait and see." One strategy is to build a bond ladder where you diversify your portfolio across a maturity range. Another strategy is to build a barbell where you split your portfolio between long maturities and short maturities.

For more information on either of these bond portfolio strategies, please consult your RBC Wealth Management financial advisor.

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