skv group

faith . discipline . patience

Fixed interest bond prices and interest rates sit on opposite sides of a seesaw.

Many bond investors may have been surprised this year when they saw their bonds drop in value. This year, according to Thomson Reuters, the Barclays Aggregate Bond Index, often used as a bond market benchmark, dropped 13.2% year-to-date on June 14.

During this period the interest rate on the 10-year government bond rose from 1.51% to 3.48%.

To understand this inverse seesaw-like relationship between the price of a fixed-interest bond and current market interest rates think of bonds as contracts.

A borrower promises to pay a lender a certain interest payment amount on a regular basis, and the principal at the end of the loan.

Today, the government sells bonds, i.e. they borrow money from bond investors, and as of this writing the interest rate on a 10-year loan is 2.76%.

So, for a $100,000 investment you'd receive $2,760 per year (half the amount in semi-annual payments) for ten years and at the end of the period you'd get your original $100,000 investment back.

Next, let's say the interest rates for ten-year government bonds goes up to 4%. That means a second investor at that point could buy a similar bond paying $4,000 per year.

If the first bond investor at this point wishes to sell his bond he'd be offered less than his $100,000 original investment.

After all, why would the second investor pay $100,000 for the first bond paying $2,760 per year when she can go to the open market and, for the same price, get a bond paying $4,000 per year?

Of course, she wouldn't.

Instead, she might offer to pay less than $100,000 to make up for the $1,240 annual difference.

Since current interest rates in this case went up the price of the old bond dropped.

Rates up, bond price down.

The dynamic is the same if rates go down. Then, the old bond would increase in value as it pays more than what is currently offered.

Rates down, bond price up.

The original bond purchaser may regret his purchase when he sees the bond drop in value. But he will also know that if he holds the bond till maturity he'll see the price eventually recover to $100,000.

If you buy bonds with fixed interest payments remember that the price of the bond may go up and down until maturity due to fluctuations in market interest rates.

Good luck.

Jorgen Vik, CFP®
CERTIFIED FINANCIAL PLANNER™
Partner
SKV Group, LLC

1405 Rolkin Ct., Suite 202
Charlottesville, VA 22911
toll free 844.391.3610
tel 434.328.8040
fax 434.234.3789
www.skvgrp.net

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