IFB305: Evaluating Investments Beyond Stock Prices: A Deep Dive into Business Performance

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Dave [00:00:00]:

All right folks, welcome to Investing for Beginners podcast. Today we have episode 306. Today we are going to focus on one question and one question only. This is going to cover the topic of bonds. So we got this great question and we thought maybe we could dedicate a whole show to this. So here we go. Could you dedicate a show to bonds? Yes we can. From my reading, it is important to blend bonds in with stocks, but I'm not sure how to select them. This is from beansy from Spotify. So I guess maybe let's start off talking about what is a bond. So what to you is a bond? Andrew?

Andrew [00:00:33]:

When I think about bonds and kind of where that sits in the investing world, I think if you go to the two extremes, on one side you're leaving cash under your mattress, on the other side you're buying a lotto ticket or buying the smallest cryptocurrency that's ever been created. Somewhere in the middle you have stocks and then somewhere more on the risk averse or not trying to take a lot of risk, you have bonds. And so bonds are very attractive because you know what you're going to get with a bond. With stocks you're owning a piece of a business. So a business could grow, it could shrink, it could grow a lot, it could grow a little bit, so the value of that business changes. But when you get a bond, a bond is basically you lending your money to somebody else and you know that you're going to get a certain number of payments back and so you know what your return is going to be. If you buy a 3% bond over ten years, you'll get 3% every year back. That in addition to whatever you put in. So it's definitely more on the safer side than a stock because you know what you're going to get but it also doesn't have the same upside as a stock because you know what you're going to get. So there's a ceiling there.

Dave [00:01:45]:

Yeah, exactly. So for those who are not really familiar with what bonds are, andrew laid it out really well. The easiest way to think of it is it's debt of another company. When you are investing in Microsoft and you buy a bond from Microsoft, you are not buying a piece of the company like you are with the stock. What you're doing is you're buying the debt. So you're basically, like Andrew said, you're lending Microsoft the money, you give them $100 and they will give you a coupon, a dividend for however long you agree to loan them the money. And then they will pay you back the value that you loan them at the end of the contract and you'll receive those dividends along the way. And so in essence, Microsoft is borrowing the money from you and then you'll get it back. And so it's based on the financial strength of the company as opposed to how well it's going to do in the market. It is somewhat correlated but not necessarily. And so when you think about a bond, think about a safer stock but potentially a better savings account. And so if you kind of think of like Andrew was talking about the really wide extreme, bonds are probably a better return investment than maybe putting the money in, certainly better than your mattress and probably better than putting it in a savings account but not as great as investing in a stock. And so if you look at kind of the history of returns that you can get from different asset classes, bonds being one of them, they always come in below stocks. There are different periods of time where maybe they outperform stocks depending on the volatility of the markets. But if you look at it over a longer stretch of time, 20, 30, 50 years, stocks are going to outperform bonds almost every time. And so you have to go into it knowing that if you do invest in bonds that you cannot expect the same return that you would get from buying Apple or Microsoft for example. You could buy their debt, you could invest in them by giving them their money and they will give you a good safer return, but you will not get the same return that you would from there. So you have to go into that understanding that because if you go into it expecting, hey, I bought the debt of Apple, I bought a bond from Apple and now I'm going to make all this money because Apple is going straight up because they just introduced a new iPhone and everybody and their brother wants it. It doesn't necessarily work that way. So just understand the expectation of investing in bonds and kind of how that works. So maybe we can talk about now that we've kind of maybe defined a bond, maybe we can talk about why people would choose to invest in bonds versus stocks or how they would kind of incorporate that into their portfolio.

Andrew [00:04:32]:

Yeah, I definitely think it's a case by case basis, I guess for you. What type of investor do you think? Obviously somebody who doesn't want to take as much risk. But are there categories of investors who bonds would generally be a better fit for?

Dave [00:04:47]:

I think if you look at the, I guess traditional or air quote stereotype, you would probably look at more conservative investors, maybe older investors, people that are closer to retirement would look at something like bonds as a potential for preserving their capital. The bond market generally is not near as volatile as the stock market is. And so the theory is and in practice when you get closer to retirement you want to start moving a portion of your money out of the stock market into something safer like a money market account or bonds because you can still earn a decent return. But it also doesn't expose you to the volatility of the stock market. If you are investing in the stock market three weeks before you retire and a pandemic hits and the market drops and it takes five or ten years to recover, that could be catastrophic to people that are pounding on those savings to help them through their retirement. So that is why you would consider rotating your portions of your portfolio to that target date funds, which are something that are really popular, especially among investors in 401. Kind of the way that they structure those target date funds is, let's say that you start investing and you're 25 years old, they will look at, okay, if you're going to retire in 50 years, then let's say that you work for I'll pick Target. You work for Target for 50 years and you start investing in the 401K. In a target date fund, no pun intended, your investment will be greatly towards stocks because you have a time frame that you can withstand the volatility. And as you get closer to retirement, let's say you're now 30 years into working for Target, the portfolio would start rotating more and more and more of their percentage towards bonds. Let's say maybe it starts at 90 stocks, ten bonds. At first it would be 100%. When you're 25 start working for them, it would be 100%. But as the target date fund gets closer to retirement, it would start shifting. And so by the time, let's say, you're ten years out, it may be 60 40 or 50 50, depending on your allocation, because you still are in control. But as you get closer to that retirement date, it'll start rotating out of stocks into bonds because they're considered safer and it would be a better way to manage your money as you get closer to retirement and you can still earn a decent return on them. So maybe let's talk a little bit about, I guess, did you have any other thoughts about allocation or anything like that?

Andrew [00:07:17]:

Oh, that's great.

Dave [00:07:18]:

Okay. Maybe we could talk about kinds of returns that you could kind of expect from bonds. Again, going into it, what should you kind of expect?

Andrew [00:07:27]:

Like you said, it can vary greatly depending on the time period. Just off the top of my head, I think somewhere around 5% a year on average over the very long term is something you can kind of use as a starting point. If you think stocks can return around ten, real estate maybe five or six, and bonds, maybe five or six. That's generally, obviously we're talking about huge averages here. There can be a lot of differences depending on the individual bond. But yeah, in general that's around what you can expect to see. But there is still a risk in investing in a bond, so maybe we can talk about that.

Dave [00:08:03]:

Yeah, for sure. So when you invest in bonds, you have to realize that there are different levels of bonds and there's different kinds of bonds that you can invest in. And so the safest bonds that you could invest in would be the bonds that you could buy from the United States government. So treasury bills, treasury bonds, those are bonds. You're buying debt of the United States. And in essence, again we're giving them $100 and they're using it for whatever they need. And then at the end of the 510 one year, whatever it is, the term, they give us the money back and then we earn a dividend on top of that to loan the money. And those are considered the safest because up until recently it was AAA rated bond which is the highest rating that you can get for credit and they were backed by the full faith and confidence of the US government for example. And so you can get very safe, maybe not as safe as the savings account but pretty darn close and you can get better returns than you can from Wells Fargo, which isn't saying much, but so that's kind of the first level of bonds. Did you want to talk about maybe the next tier down, if you will?

Andrew [00:09:13]:

I guess from there you could go down to municipals. So for example, Orange County could have a bond and maybe they're using it to finance a bridge or something like that. So counties can and have gone bankrupt. I know Orange County in California went bankrupt in the early 90s so that stuff does happen. But to your point it is a pretty safe bet most of the time and usually with bonds it's even more so than stocks because I think sometimes you can have stocks that might seem more risky but in reality they're not. And so you kind of get to eat your cake and have it too and you buy like a lower risk stock and get higher returns. Again sometimes well, with bonds it's almost very straightforward where the higher the interest they're going to pay you on the bond, the more risky that bond is. And when we say risky, we mean the risk of default where whoever is borrowing from you is not able to pay you back. So in the case of the United States government hasn't been

a risk up to this point. In the case of municipalities, some of those have gone bankrupt. And you can keep going further, further down the chain until like you were saying at the beginning, Dave, you have a company like Microsoft or Apple or some speculative construction company who has like a C rating bond with a super high interest rate. You can kind of go along that scale. And that's, I guess, what makes bonds interesting a little bit. But in practice when it comes to like if you're talking about the target date fund or a lot of the bond funds that most individual investors can access, those tend to buy baskets of bonds anyways. And so if I were to buy a bond ETF that had 100 bonds that it held yeah one of them could go default but because they have 100 in there it's not going to impact my personal return with this bond ETF. And so that's kind of the practical part of it is a lot of bonds require they only sell them in huge quantities so you have to have $10,000 buy a bond. So in practice we have a lot of other avenues or vehicles that you can invest in bonds where they will buy the bonds for us, hold them in a basket and then we can just buy that basket directly. But the whole concept is still the same where you can buy more risky bonds to try to get the higher return or you can buy the safer bonds and get a lower return. It's the same thing just done at a different scale and I wonder if that's why it can be sometimes a little intimidating or complex or just seem a little just out there because it's not as clear when things get muddied up. But in essence that's what you're doing when you're either allocating to bonds in your four hundred and one K or buying a bond fund directly through ETF that's basically the same thing.

Dave [00:12:13]:

Yeah exactly. And when you're investing in bonds so Andrew was talking about potentially better returns but also greater risk if you keep kind of going down up the value chain down depending on which way you want to look at really. I guess the next level after more the government level ones are the corporate ones and those kind of come in two tiers. You have corporate bonds and then you have what you would call high yield bonds or they're also known as junk bonds too. It's not as flattering, they changed that to high yield a while ago to make them more enticing. But basically it comes down to the corporate bonds are the bonds that you would buy of individual companies whether it's Tesla, whether it's Nvidia, whether it's Apple, Microsoft, those are all corporate bonds. But you can buy ones that are safer but they're going to offer lower returns for more security. So something that like Microsoft is that and Johnson Johnson are two of the Johnson. Is Apple in there now or Berkshire?

Andrew [00:13:18]:

Apple has been in there. Johnson Johnson just went through a separation so they may or may not.

Dave [00:13:23]:

Yeah they may or may not. I know Microsoft for sure is one of the few AAA rated bonds which right now is actually higher rated than the US government so it's considered the safest bond out there. But the flip side of that is it also would offer the lowest return because you're exchanging the safety for a higher return when you look at some other types of corporate bonds. Tesla I don't know where they're rated now but I know for a while early in their career, if you will, is they were considered a high yield or a junk bond because it was very low rated. And to take on that risk of investing your money in Tesla with their bonds, then they paid a higher yield or a higher dividend. And so you got a better return for taking on that risk. And you can kind of think of it as a pendulum. And so the lower the risk, the lower the return. And kind of likewise, the higher return is the higher the risk. And so it just kind of flips on this pendulum. And when you're thinking about investing in bonds, you can get a better return, maybe not stock like, but closer to that, but you have to take on a lot more risk, and that would be with those high yield bonds. And when you talk about bonds, particularly corporate bonds, one of the big things is the ratings. So we've mentioned that many times. AAA, so Moody's, S, P, Global and Fitch are the three agencies that do these bond ratings. And they basically assess the financial strength of the company and determine how strong the financials are of that company, including any outstanding debt they have, any other obligations, what kind of revenue they're generating, free cash flow, all of those things. It goes into the rating of a company. And that's how, as investors, we can sometimes look at these companies. It's a good way to look at the strength of the company financially, is looking at the rating. So if you're going to buy Microsoft as a stock, you could look at the bond rating of the company to give you some sort of sense of how financially fit the company could be. And if you're going to buy corporate bonds, that would be absolutely one of the things you would have to check would be the Moody's rating or the S and P or the Fitch rating for those companies. But like Andrew said, one of the drawbacks to investing in bonds is peasants like me. If you want to buy an individual bond, you got to come with the cash. You can't just buy one for like $30. You got to buy tens of thousands, if not hundreds of thousands of dollars worth of bonds. You cannot buy them through Fidelity Brokerage account. You have to go to a separate entity to try to buy the bonds. It's not easy to do as an individual advancer. So that's something to kind of keep in mind if it's like, hey, this sounds great, I want to invest in bonds. So doing it individually is a bit more of a challenge, unless you're coming with a big bankroll. If you're not, then we got to talk about bond ETFs and that kind of thing. So what are your thoughts on those?

Andrew [00:16:19]:

Yeah, of course it's the only practical way outside of allocating to an ETF or again, having the allocating four hundred and one K or having a target date fund or something like that. I personally don't buy bond ETFs, so I'm not the person to ask on the topic itself. But we can talk about some of the risks there because I think

what's a little bit confusing about let's say you buy a bond ETF. I can't even give you a ticker, so sorry about that. But if you buy a bond ETF, the price of that actually does move up or down. And that's what's confusing too is like if you were to invest in a bond, everything like we just said leading up to this, for this whole episode, you're lending the company or the government money and you're getting that money back over time with interest. There is no worry about the bond price going up or down because in that we're kind of assuming you're holding it until the bond is done and you're getting all the money. I guess what does happen a lot behind the scenes is people trade those bonds, especially in big institutions, will trade those bonds back and forth and back and forth. And so the prices of the bonds themselves will change and that kind of adds its own little monkey wrench into it. And then the fact that if you buy a bond bond, if you're buying 100 bonds instead of one bond, then you really are getting the same price movements of those bonds as if you had bought each bond individually. And it gets a little more tricky. And I don't know if it's worth us kind of breaking it down. But if I were to buy 100 bonds individually, then let's say tomorrow I get a new bond and it's done. And then the next week I get a new bond that's done. I can kind of keep track of that myself, but because it's an ETF and they're doing something like that, but the ETF is constantly putting in new money and new bonds. So there's just constant action. And that's why the price of a bond ETF will actually move up or down. And you would think it would just be flat because they're just buying this very not risky asset, but it does move because they're constantly having bonds finish and then adding new bonds and then the prices on those move. So there are some things that move the price of bonds that can be kind of complicated, but the end result is still the same if you're holding it over the long term. So what part of that do you think would be easiest for an investor to start to understand when it comes to why does a bond fund move up and down in price and how can I get over that and still feel okay about investing in a bond? Because, hey, I thought the price wasn't supposed to move. Why is the price moving?

Dave [00:19:02]:

Right? I think it would come back to kind of the same ideas you have to embrace when you're investing in stocks like what kind of return am I looking for and how much risk am I willing to take on. And you can diversify in a bond fund or use a variety of bond funds to create different kinds of returns just like you can with stocks. And so if you want less volatility and also less returns, you can buy government bonds whether they're Treasuries or whether they're municipals. And if you want more returns, then you can buy funds that are going to focus on different kinds of bond funds as well as more of the high yield funds as well. And so all those things are going to have greater and greater volatility but also different kinds of returns. And so I have seen articles where people talk about kind of how you can kind of stagger different funds together to create an overall return, understanding that maybe the high yield funds are going to be more volatile and they're going to move more in correlation with the stock market than Treasuries are, for example. And so that can also balance out the lower return that you may get with a treasury fund. And so people will kind of stagger or

adjust their allocations to those different funds to try to overall they want a 5% return, but they can't just do that with high yield funds or they can't just do that with treasury funds. So they have to kind of mix and match. From what I've seen, that's how people will try to maximize their returns and also give them maybe some exposure to some volatility but also kind of balancing out risk. And it really comes back to your risk profile and how much you want to really kind of play with the whole market and how much the funds can or can't move.

Andrew [00:20:58]:

Yeah, that's a really good way to approach it. I would have never thought of that. Because the prices do move depending on the different scenarios. One big example of big price moves is where interest rates go. So the price of a bond and interest rates are inversely correlated. As the price goes down, the yield goes up. And without getting into the whole minutiae behind that, that means if interest rates rise over the next twelve months, your bond fund, regardless if it's government super safe or if it's risky corporates, your bond fund will probably go down in value if interest rates go up. But the reason why it's a much lower risk than stocks is because where stocks might crash 2020 5%, if interest rates go up, your bond fund again, depending on which one you choose, might go down 3%, 2%, whatever it is. So I like that idea of kind of staggering or kind of diversifying within the types of classes and they also have what are the tips which can protect you against interest rate risk, which is what I'm talking about here. And if you're really looking to keep that price steady because you don't want to see even 5% down. You might look into something that moves with inflation which tends to go up in value when interest rates go up.

Dave [00:22:21]:

Right.

Andrew [00:22:22]:

That could be an option too.

Dave [00:22:23]:

Yeah, exactly. I was reading an article earlier, the person was talking about how you can use because of the volatility in interest rates especially over the last year or so they've skyrocketed as those continue to be

volatile. People have used different lengths of treasury bonds to offset that. So the longer dated bonds without getting into all the minutiae the longer dated bonds have a lower yield where the shorter term bonds have a higher yield. And so they kind of use a mix and match approach to help kind of smooth out the returns of the bonds because as the rates fluctuate a lot the shorter term rates may fluctuate a lot but the longer dated ones will not move as much. And so you can kind of not play the system but you can kind of use those to help I guess smooth out the returns and help alleviate some of the potential volatility that you may see from rising interest rates. And that's why the bond market moves so much on the news from the Fed when they're going to raise rates and whatnot where the stock market may or may not move as much depending on the perception of how that's going to impact everything long term. But the bond market is very sensitive to interest rates and the tip idea, the tips bonds those are a fantastic way to kind of help you offset some of that volatility. That's a fantastic idea.

Andrew [00:23:48]:

So it starts to sound really complex.

Dave [00:23:50]:

Yeah, it can be. Yeah, for sure it can be. I mean one of the things that I was looking at before we came on the air is again the big bond funds are things like Vanguard ishares BlackRock, all those companies investco. All those companies specialize in having large bond funds that you can buy and if you're somebody that you really want to have some exposure to bonds for whatever reason and you don't want to go through all the games of trying to diversify, maximize returns and everything ishares has this core US aggregate bond ETF. It's ticker AG and it has over 11,000 US dollar denominated bonds and the maturities of those range from one year to 20 years. And so basically what that means is it's kind of like an all market bond fund and so it would allow you to have some exposure to a wide range of different kinds of bonds and you don't have to monitor the ins and outs of it. And it would be a good way to kind of dip your toes into starting to get exposure to bonds if that's something that you want without getting into all the minutiae of all this. One of the things that I always go back to when I think about investing in bonds versus stocks is think about where you are and the evolution of your scale of where you're investing and how. If you're 25 and you're just starting out. I wouldn't say don't invest in bonds, but I would probably say don't invest in bonds because you have so long to invest and overcome any sort of hiccups in the market. And they're going to happen, but you have so much time to recover from that. But if you're like me and you're 56 and you're closer to retirement, then considering looking at having some exposure to bonds is probably not a bad way to go, because you can start to offset some of that potential volatility. Because none of us know when the next black swan

event is going to hit or when the next pandemic could potentially hit. And it would be tragic to get close to the finish line and have something like that pop up. So those are some of the things that I guess I think about when I'm kind of thinking about investing in bonds. But there is bonds for Dummy is a book that I read a while back that I checked out from the library. Yes, the library. It's still a great resource to find good stuff and it was a fantastic book to give you me a great overview of what bonds are, potential ways to invest in bonds, and just kind of the whole nitty gritty of all that. And I've written a little bit about bonds as well on the website@einvestingforbegetners.com just to kind of try to help educate myself about them as well. So I think those are some potential good resources to look into this as well.

Andrew [00:26:33]:

It's tough because I'm looking at a lot of the different bond ETFs. So for example, Vanguard is probably one of the biggest ETF providers. They have a total bond market index fund like you said, and that's ticker BND, so you could buy that, have bond exposure tomorrow in your brokerage account. The problem is a lot of these bond ETFs have only been around since 2000, 1990. While that might sound like a long time, it's really not a long time in the scope of financial history. Again, I don't invest in bonds, but I can't imagine looking at the stock price ticker. Again, like we said, it's a very low risk, lower volatility asset. If you looked over the years, maybe 5% up, 5% down in that range. But then in 2021 when interest rates first started to climb and then they shot up at an unprecedented rate, your bond fund since then is down 15, 20% and it's like, hey, this was supposed to be a safer asset, right? And so it's a really, I think, sensitive and maybe tough subject in that regard because interest rates have a really long history and they do affect bonds. And unfortunately, what happened in the last two years was. An unprecedented fast increase in interest rates. And so a lot of these ETFs did lose a lot and a lot more than you would have thought they would. And because the history of these ETFs doesn't span back to 1980s, which is the last time we saw huge rate increases, we never had that context and so a lot of investors got burned from that. So I guess with that backdrop, what would you tell somebody? Who is it? Throw up your hands, talk to a financial advisor. Because rates could go up to 810 from here. They totally could. That wouldn't be outside of the span of history.

Dave [00:28:30]:

No, not at all. Would it?

Andrew [00:28:33]:

Has it become one of those things if you have enough money it's worth becoming an interest rate expert and a bond expert and a maturity expert or is it better left to know? What are your thoughts around that? It's a tough question.

Dave [00:28:48]:

Yeah, it is a tough question. So there's a few things that kind of spring to mind. So number one, Warren Buffett is actually one of the largest buyers of bonds which may shock people. He buys a ton of treasury bonds which are safe, lower yield and that's kind of how he chooses to do it. He does that for the business because he doesn't have a place to park the cash and so buying the bonds earns him a better return. But he's using shorter dated funds and he's Warren Buffett, so I'm not so there is that huge difference. If I was really interested in this, I would talk to somebody that is more of an expert in bonds and see how it is that they're playing this. One thing to keep in mind, the bond market is tripled the size of the stock market. It may even be bigger than that. So it is a huge, huge market and there are a lot, a lot of smart people that invest in this area. And I think if you talk to a financial advisor they would be able to guide you in a direction that would probably be a better way of thinking about that. And sometimes maybe bonds may not be the choice for you at the moment. Maybe looking at money market funds or something along those lines might be a better option in the short term until the rates stabilize. And that would be, I guess, something to think about as well. Like Andrew pointed out very astutely, this is unprecedented times with interest rates, we're coming off record level lows and so everything is going up and that's going to be quite the shock to the system. And so investing in this asset class would be harder than it's been in the last five years. And so if you're really serious about doing this, I would want to talk to a professional. That's what I would do.

Andrew [00:30:32]:

Would you not? Allocate then if you're in a 401K?

Dave [00:30:37]:

That's a good question. I would probably try to talk to a professional before doing it.

Andrew [00:30:42]:

Okay, that's fair.

Dave [00:30:43]:

Yeah. Just because there would be a couple of qualifiers to that. If I'm 45 and I have another 25 years, I may consider investing in bond ETFs if that's really what I want for my portfolio, because I have 25 years to overcome this volatility, anticipating that, lasting for that long, I wouldn't anticipate that. So I might be a little more comfortable doing that way. But if I'm 55, 56 like I am now, and I'm like, okay, I want to start putting money in bonds, I would talk to a professional before I did it because the shorter time horizon would be a stock. Recovering 15% is not awesome, but it's a lot more doable than a bond fund. Recovering 15% is going to be a lot harder to overcome. So I would want to talk to a professional before I dipped into doing something like that.

Andrew [00:31:37]:

Yeah. And the other benefit of doing that is they can help you with your taxes. So if you want to change your allocations and use that to reflect your personal, whether you're going to have higher taxes today or higher taxes when you retire, it's a lot of moving pieces. And they can help you piece that together and do it in a way that makes sense with taking the amount of risk you want to take with your investment portfolio, which can change if you're somehow an interest rate more of an interest rate Risard than we are. Or you just have a certain way that you feel is a strong way to invest in bonds. All of that can be put on the table with a good financial advisor.

Dave [00:32:17]:

Yeah, for sure. Yeah, I totally agree.

Andrew [00:32:21]:

Okay, we're probably done.

Dave [00:32:23]:

Okay, everyone. Well, with that, we will go ahead and wrap up our show for this week. Don't forget to subscribe to the show on your preferred podcast app. If you enjoyed our little show, if you would kindly

consider giving us a five star review, it greatly helps our show. And don't forget to browse the incredible materials we've created for you@einvestingforbeganners.com last week. Continue growing your knowledge as an investing for Beginners Insider with insights and educational tips delivered right to your inbox for free. Sign up today. And with that, we will go ahead and sign us off. You guys go out there, invest with margin of safety, emphasis on the safety. Have a great week and we'll talk to you all next week. Bye.

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