

Some investments you might think are safe actually can be losers

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By Tim Grant, Pittsburgh Post-Gazette

Investors who can't make sense of today's stormy stock market might think the safety and security of bond mutual funds and money market accounts are a way to avoid losing money.

But many of them have opened their monthly statements only to discover they've had a negative rate of return in their fixed income accounts, and come to the sobering realization that when it comes to investing there's no such thing as a sure thing.

"What people need to realize is that even though their fixed income investments pay a fixed interest rate, their principal dollars will fluctuate with market conditions," said Nadav Baum, managing director of investments at BPU Investment Group, Downtown.

In other words, if an investor owns a bond paying 5 percent interest until it matures, he will receive that fixed dividend for the life of the bond and get all of the principal back. But the actual value of the bond will fluctuate daily based on current interest rates and company and industry risk.

At any given time the current value of an individual bond or a bond mutual fund may be worth more or less than its original cost due to daily price changes.

"My clients frequently think because a bond fund is liquid and they can see a price every day, it's a short-term investment, but sometimes the bonds inside that fund are very long -- up to 30 years," said Bill Glassner, a managing executive at Royal Alliance Associates in Cedar Knolls, N.J.

Some bond mutual funds are actually disguised as high-yield money market funds, which explains why a money market balance might show a monthly decline. Also, financial institutions that lost money on commercial paper or by betting on auction rate securities have passed those losses on to their customers who own money market accounts.

"With the subprime loan mess, the market for auction rate securities has dried up, and these banks have not been able to maintain the \$1 share price [for money markets] and the value has declined," said Jeff Harris, president of Jeff Harris & Associates in Harrisonburg, Va.

"This is very unusual," he said. "You hardly ever see something like that occur. But, nonetheless, that's what we are dealing with."

The most recent example of fixed income bond funds that have failed miserably are the Morgan Keegan fund, which has lost 80 percent of its value in one year, and the Charles Schwab YieldPlus Fund, which has lost 30 percent of its value in six months.

"There are a whole bunch of hidden risks that investors have no idea about," said Andrew Stoltmann, a securities attorney for Stoltmann Law Offices in Chicago. "A lot of bond funds have high-risk investments in them, and those risks aren't made clear to investors."

Customers who suffer heavy losses in a bond mutual fund have two courses of action they can take, he said.

Sometimes they can join a class action lawsuit if one pops up, although the average recovery is often small. The only other recourse is through the FINRA (Financial Industry Regulatory Authority) arbitration process.

"I talk to fixed income investors who have lost massive amounts of money, and very often the first words out of their mouth is, 'I didn't know I could lose money,'" Mr. Stoltmann said. "People have their guard down when it comes to bonds and bond funds."

Bond prices and bond interest rates move in opposite directions.

If interest rates increase, the value of old bonds decline because newer bonds can be bought for the same amount with higher

yield. Bond mutual funds hold bonds of varying maturities and interest rates, and the fund is valued each day based on current market conditions.

"The price of General Motors bonds are dropping because investors are concerned about the automobile industry, which is another factor that affects bond prices besides interest rates," Mr. Baum said.

Money market mutual funds are really mutual funds that invest in short-term debt instruments, such as auction rate securities.

Many financial institution invested their money market funds in auction rate securities to boost yield, but in doing so they took on higher risk.

Rating firms such as Standard & Poors and Moody's contributed to losses in the fixed income universe by posting artificially high ratings for auction rate securities, which gave a false impression of their stability.

Todd Chesterpal, a senior investment adviser at PNC Wealth Management, Downtown, said that instead of buying bond funds, he usually advises clients to build a portfolio of individual bonds with laddered maturities.

"Bond funds can fit in certain situations," he said. "But typically we've found we can achieve a client's goal using individual fixed income securities, not funds.

"We're proponents of a diversified investment strategy because regardless of what type of vehicle clients invest in, there are risks associated with all of them."

Most investors are unaware that as interest rates rise bond prices fall, and it's very possible to lose money in a bond fund, said Kim Snider, author of "How to Be the Family CFO: 4 Simple Steps to Put Your Financial House in Order."

"Money market funds are a different story," Ms. Snider said. "The idea is that a money market fund invests in very short-term, very safe investments. The value of the money market fund is supposed to remain constant at \$1 per share, and the holder is paid interest on the investment.

"In recent months, however, some banks have been caught with their pants down. It turns out they were investing in some of these troubled short-term debt instruments. At that point, the bank has two choices to prevent a crisis of confidence -- put its own money in to prop up the value of the money market or allow it to 'break the buck' [fall below \$1]."

Lyn Dippel, a vice president and senior adviser at Financial Advantage Inc., in Columbia, Md., said no one can be guaranteed they won't lose money in a bond fund, but she suggested some strategies to make sure it's less likely.

Investors should buy bond funds that invest in only U.S. treasuries as a way to reduce risk. Theoretically, Treasury bonds can't be downgraded as a corporate bond could be.

Also, they should buy shorter term bonds.

"Long-term bonds are more volatile and sensitive to interest rate changes and credit ratings," Ms. Dippel said, adding that investors will sacrifice some yield for the safer quality bonds.

"Most people are concerned and shocked when their bond fund loses value," said Jonathan Gassman, director of wealth management at G&G Planning Concepts in New York.

"They've always looked at bonds as a safe way to protect invested principal. They think bonds are there to pay out regular income rather than the fact that they are taking on risk in search of superior returns."

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