



finances and you
**Sid
Mitra**

Bond market is unsettling

This column was inadvertently run without the chart.

Last week we argued that inflation does reduce the real return of a bond. We will elaborate on this point.

Concept of real return:
For the most part, we are used to dealing with actual dollars we receive from a bond investment. Converted as a percentage of the total investment, the rate of return gives us the basis for comparing a bond's return with other comparable market investment.

For example, if I invest \$1,000 in a bond and receive \$80 every year, my return is 8 percent (80/1,000 times 100). This is called the nominal return.

If I adjust it for inflation which is running at say, 5 percent a year, my real rate of return, or inflation-adjusted rate of return, is just 3 percent (8 percent minus 5 percent).

The record:
The accompanying chart, prepared by Kiclawort Benson Government Securities Inc., shows the nominal as well as the real, or inflation-adjusted, yield on 30-year treasury bonds for the period 1981-89. Notice that even though the nominal rate was as high as 13 percent at the beginning of 1981 and around 9 percent in May of 1989, the respective real rates on those two occasions were only 3.9 percent and 4.3 percent. In fact, the real rates now have

dropped to their lowest levels since 1982.

The prognosis:
It is rather worrisome that despite significant drops in inflation-adjusted yields on long-term bonds, presumably because of high (8 percent) nominal returns, investors have been snapping up long-term bonds, contributing to the bond market's current rally.

I am not implying that investment in long-term government bonds is bad; in fact, depending upon individual circumstances, it can be an attractive addition to a diversified portfolio.

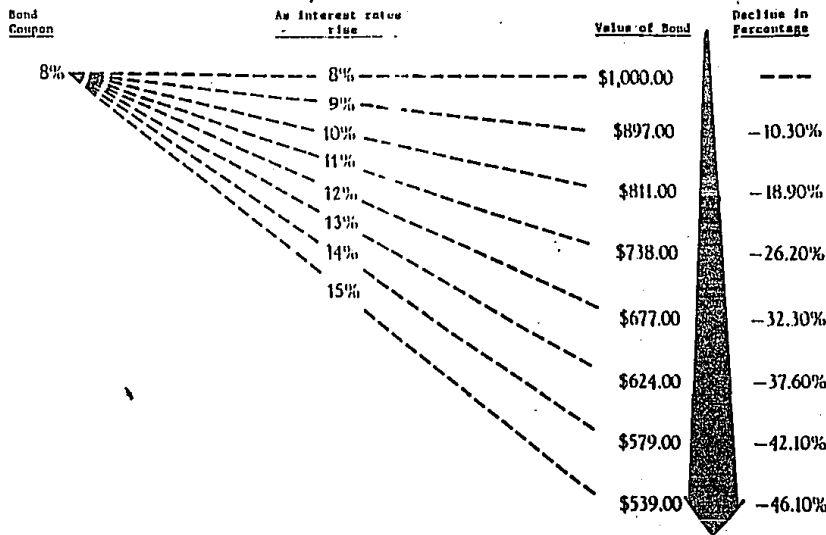
However, caution should be exercised before making a decision to invest in fixed income securities.

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A \$1,000 INVESTMENT IN A HIGH GRADE BOND AS INTEREST RATES RISE WITH AN 8% COUPON



marketplace

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