Bonds and Your Retirement Savings Plan

Many people emphasize stocks over bonds in their retirement savings plans because stocks have historically offered more potential for inflation-beating growth. But stocks don't deliver growth every year. When stocks falter, it's comforting to have some of your retirement savings shielded by the low volatility and steady income that bonds can provide.

Defining the Markets
The first way to differentiate bonds is by issuer. Retirement savings plans often offer funds that invest in a variety of bonds including:

Government bonds. The U.S. Treasury sells bonds to finance government operations and to pay down the national debt.

Corporate bonds. Businesses sell bonds to finance growth and new investments.

Government bonds are considered to be very safe, because they are backed by the full faith and credit of the U.S. government. But corporate bonds pose a slightly greater risk because they are backed only by a company's good standing and ability to repay the debt—so they pay a slightly higher rate of interest.

The second way to differentiate bonds is by their length of issue. Retirement savings plans often offer funds that invest in:

Short-term bonds that mature in three years or less
Intermediate-term bonds that mature between three and 10 years
Long-term bonds that mature in more than 10 years.

Long-term bonds pay the highest interest rates, to reward investors for committing their money for many years. Short-term bonds are the least volatile, since investors are assured of getting back all their money in only a few years. Intermediate bonds split the difference.

Bonds vs. Bond Funds
Your retirement savings plan is likely to only offer bond funds—and there are differences between bond funds and individual bonds.

First of all, individual bonds pay a stated rate of interest, set when the bond is issued. The day you buy the bond, you know exactly how much you will earn until the bond matures. But the portfolio of a bond fund is always changing, and so is the yield on your investment. With a bond fund, you can't know from one day to the next how much income you'll earn.

Next, if you hold a bond until maturity, you'll get back all your original investment. But bond funds keep going indefinitely, with the manager buying new bonds as older ones mature. If bond prices are up when you sell, you'll get your initial investment back. If they're down, you won't.

Finally, because you can pick the maturity date of individual bonds, you can custom-tailor a bond portfolio so the money is there when you want it. You can't do that with bond funds.

So, make the most of the ease and convenience of investing through a bond fund. Then consider individual bonds outside of your retirement plan with maturities chosen to fit your financial needs.

© 2008 SmartMoney. Prepared by SmartMoney Custom Solutions. SmartMoney is a joint publishing venture of Dow Jones & Company, Inc. and Hearst Communications, Inc. All Rights Reserved.

CustomSolutions
FROM SMARTMONEY