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THE BONDS THAT GAG

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Why in the world would anybody own bonds at today's wretchedly low yields? And yet we should.

In August, the interest rate on the 30-year Treasury bond dipped below 2%. That was the lowest yield recorded in the 42 years since the federal government first started regularly selling 30-year Treasurys. Meanwhile, the yield on the 10-year Treasury note hasn't yet revisited its July 2016 low of 1.37%. But in recent weeks, it got awfully close.

All this is at a time when annual inflation is running at 1.8%. The upshot: Unless you own the longest-dated Treasurys in a tax-free account, you're losing money, once inflation and taxes are figured in.

WE SHOULD VIEW BONDS LESS AS A STANDALONE INVESTMENT—AND MORE AS CRUCIAL PLAYERS IN A WELL-DIVERSIFIED PORTFOLIO.

Ah, you sigh, if only we could return to the good old days, like late 1981, when the 10-year Treasury yield got as high as 15.84% and the 30-year bond reached 15.21%. Sound like a bargain? Yes and no. At the time, annual inflation was running at 11%. That meant that, if you were losing 30% to federal income taxes, you weren't making any money back then, either. And many investors would have been losing 30%. In fact, in 1981, the top federal rate was 69.13%, according to the Tax Policy Center.

Even if Treasury bond buyers didn't make money in 1981, however, they made truckloads in the years that followed—as long as they hung onto their bonds. As interest rates and inflation fell steadily over the decades that followed,

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bond investors pocketed handsome gains. They may not have made as much as stock investors, but the past 38 years have generally been a wonderful time to own bonds.

This bountiful period has led to a widespread but erroneous belief—that the primary reason we buy bonds is to make money. Don't get me wrong: I have nothing against making money. In fact, I rather like it. But that isn't the principal role of bonds in a portfolio—and, indeed, in each of the four decades prior to the 1980s, bond investors lost out to inflation.

If the primary role of bonds isn't to make money, why own them? We should view bonds less as a standalone investment—and more as crucial players in a well-diversified portfolio. The real value of bonds lies in the way they complement our stock market investments.

Stocks are a portfolio's engine of long-run growth. But in the short term, there may be no growth from stocks. That's where bonds come in. First, if our stock market investments are—to use a technical term—in the toilet, we can sell from the bond side of our portfolio, thus avoiding the risk of unloading shares at fire-sale prices. Second, we can draw on our bond investments to buy stocks during market downturns. The resulting rebalancing bonus can enhance our portfolio's overall return.

Convinced? I can imagine two lingering objections. The first objection: "Everybody knows interest rates are going up, which means bond prices will go down. Isn't it stupid to own bonds when you know you'll lose money?"

If everybody "knows" interest rates are headed higher, today's interest rates would already reflect that expectation—and, in the absence of some new development, there's no reason to assume rates will climb from today's modest levels. In fact, for the entire 34 years that I've been writing about the financial markets, countless investors have been expecting interest rates to head higher. They're still waiting.

One day, of course, these investors will be right. At that juncture, bond prices will indeed go down. But guess what? While that may hurt in the short term, it'll be good for long-run results. When interest rates rise, we can both invest new money and reinvest our interest payments at the new, higher yields. This is the huge silver lining that comes with rising interest rates.

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That brings us to objection No. 2: "Why would I buy bonds today when I can earn almost as much—and maybe more—with a money market fund?"

Currently, we have what's called an inverted yield curve, with intermediate-term bond yields below short-term interest rates. Some observers believe this signals a recession. On that score, the evidence is mixed.

But while an inverted yield curve may not signal a recession, it undoubtedly signals something else: that there's a widespread expectation that short-term interest rates are coming down. After all, why would investors buy intermediate-term bonds at a lower yield if they thought they could earn a permanently higher return by sitting with a no-risk money market fund?

If that inverted yield curve does foreshadow a recession, share prices will almost certainly decline. To revive the economy, the Federal Reserve will respond by slashing short-term interest rates, and today's plump money market fund yields will promptly disappear. With stocks suffering and money market fund yields plunging, what will save the performance of our portfolios? You guessed it: As interest rates drop, those much-hated bonds will ride to our portfolios' rescue.

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