Why you **shouldn't abandon bonds**

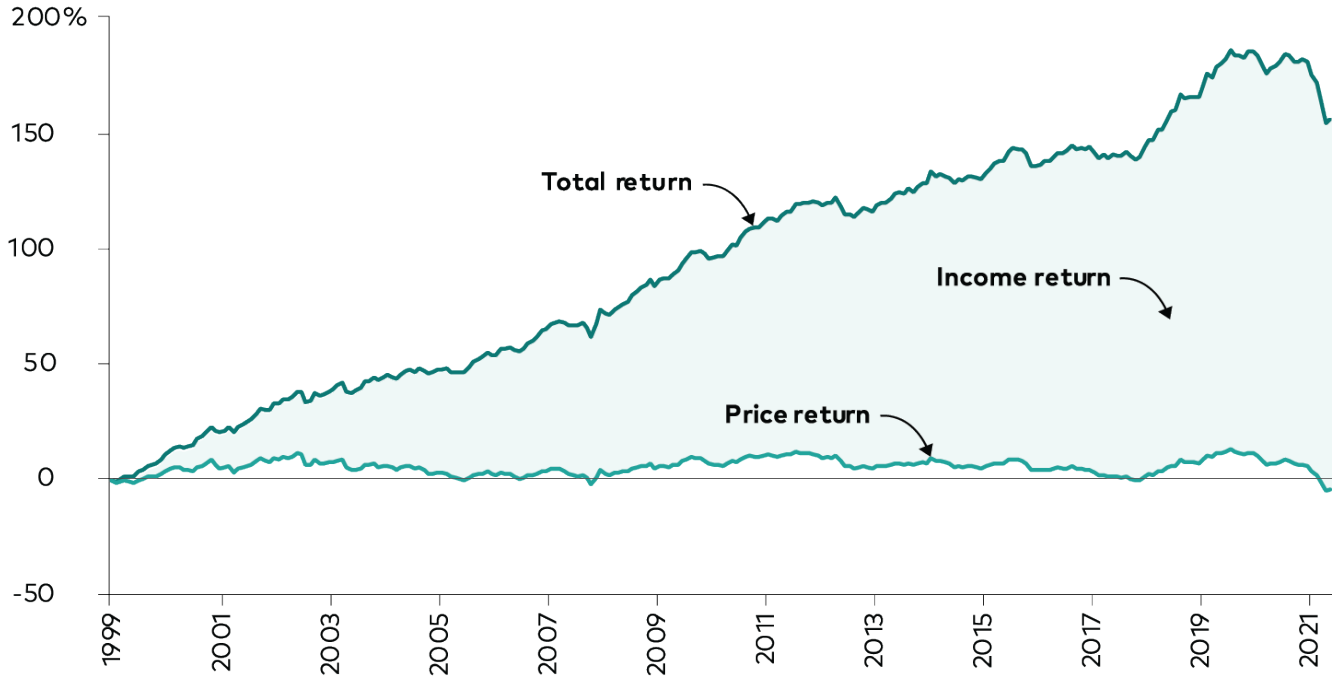
Bond prices may not matter as much as you might think they do

While swift bond price declines can be upsetting, it's important to remain focused on the long-term benefits of higher interest rates.

Bond total returns have two main components: price return and return from income. Changes to interest rates cause these two components to move in opposite directions. As a medium- to long-term investor, you should care more about bond total returns instead of the negative short-term impact on bond prices. In fact, as we show in the chart, the long-term performance of bond investments has come mostly from income return, not price return.

Price return and total return for U.S. aggregate bonds

Total return and price return



Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Notes: Monthly data are from December 31, 1999, to May 31, 2022. U.S. aggregate bonds are represented by the Bloomberg U.S. Aggregate Bond Index in USD. All bond income is assumed to be reinvested. Income return is the reinvestment of coupons and compound interest on the reinvestment.

Source: Bloomberg.

Why bond bear markets are fundamentally different from stock bear markets

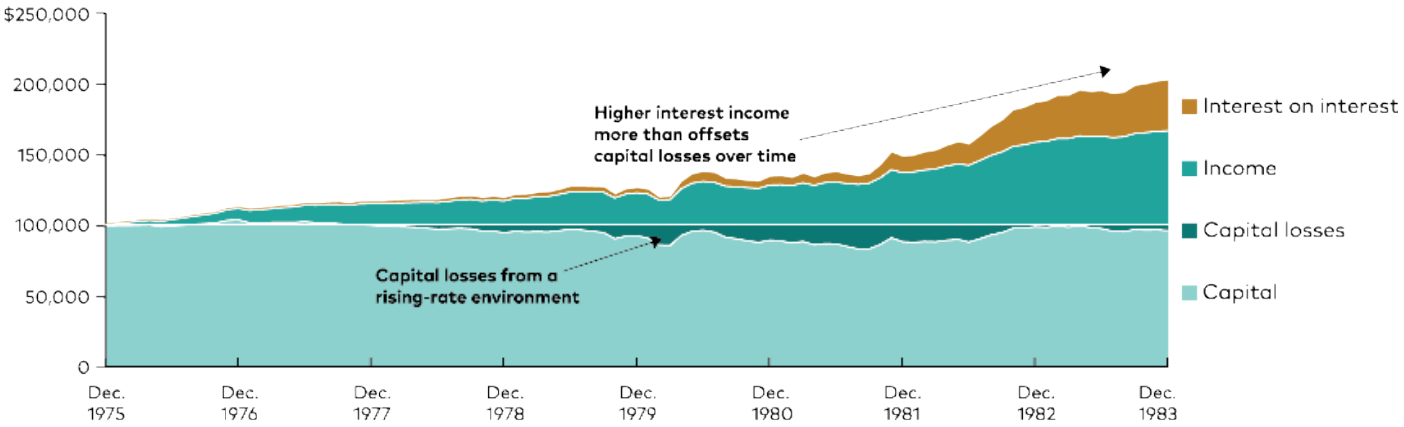
For bond investors, the price return component's effect on total return decreases as time extends. For stock investors, the price return component of total return is much more significant. "The Lost Decade" is a great example of this: From January 2000 through December 2009, the total annualized return for the S&P 500 was –0.95%, inclusive of the reinvestment of dividends. The negative price returns caused by the bear markets of 2000–2002 and 2007–2009 had an immense impact on long-term returns.

Now take the bond bear market of the 1970s, which was seen as a terrible time to have been invested in bonds as both inflation and interest rates were soaring. But consider this: Long-term bond investors who reinvested their income returns, and remained patient as compounding took hold, nearly doubled their capital from 1976–1983. Over the longer term, bond total returns are driven much more by reinvestment of interest income and compounding than by price returns. So try to look beyond the immediate pain of any losses appearing in your quarterly bond portfolio statements and instead focus on the longer-term upside of rising interest rates.

Interest income and reinvestment make up the largest portion of total return in bond funds

Bond investing in the 1970s and early 1980s

Growth of a $100,000 investment in the Barclay's Capital U.S. Aggregate Bond Index, 1976–1983



Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Notes: For this example, we assume that an investor fully funded a $100,000 investment in the Barclay's Capital U.S. Aggregate Bond Index (now Bloomberg U.S. Aggregate Bond Index) on January 1, 1976. We do not account for any expenses or taxes. Interest-on-interest return is calculated as the remainder after subtracting both income and capital returns from the total return.

Source: Vanguard calculations based on capital, income, and total return data reported by Barclay's Capital.

Bond math holds up even during fixed income shocks

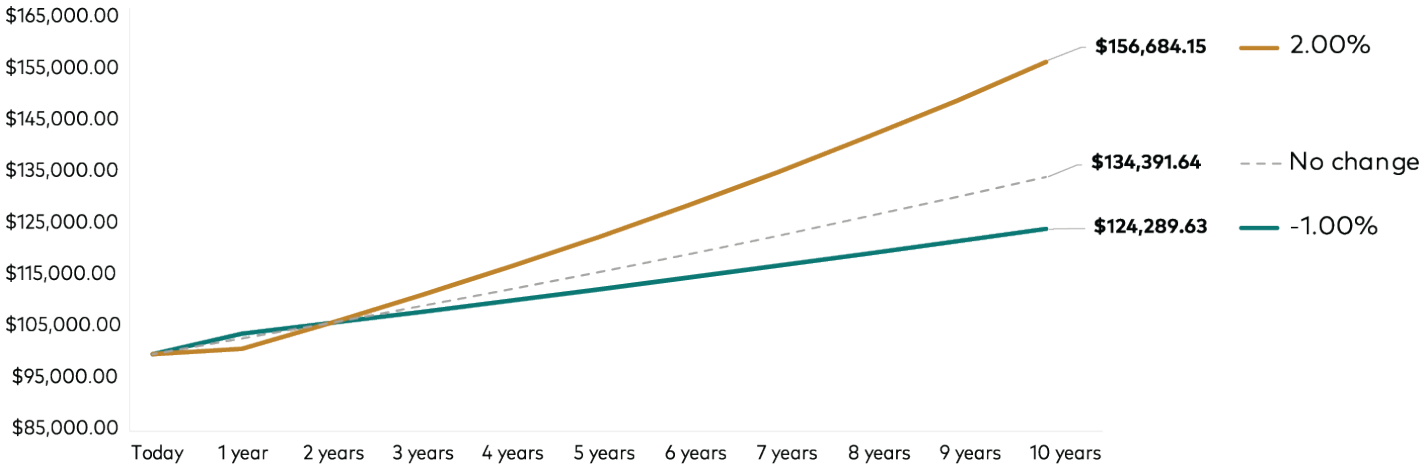
Consider short-term Treasuries: interest-rate-sensitive securities whose total returns are extremely sensitive to central bank policy changes. As interest rates on the short end of the Treasury curve have risen due to expectations of further Federal Reserve policy adjustments, so too has the weighted average yield to maturity for funds that invest in these securities. That provides a better foundation to help you weather further rate shocks as starting yields are now much higher. Even if rates were to rise an additional 200 basis points (bps) from here, you would now recoup any lost principal within a year and then benefit from higher yields moving forward—ultimately increasing the long-term value of your bond portfolios (see chart).

That means the time it takes to recoup your capital from an interest rate shock depends on your starting yield. A 200 bp rate shock from a 50 bp starting yield will take longer to break even when compared to a 200 bp rate shock from a 250 bp starting yield.

The bottom line—as your advisor will confirm—is that as rates move higher, bonds are more attractive, not less.

The silver lining in rising rates

Hypothetical impact of changes in interest rates



Notes: This hypothetical example begins with a portfolio value of $100,000 and does not represent the return on any particular investment. "No change" yields are based on a starting yield of 3%. For simplicity, duration was assumed to remain at two years, but in practice, as yields change, duration also changes. Such a dramatic change in yields, as this example assumes, would likely constitute a rather significant adjustment to a portfolio's weighted average duration. For purposes of illustration, we assumed no change to yields in subsequent years. Yields are not guaranteed.
Source: Vanguard.