

Institute Reminds Investors to Consider the Effects of Interest Rates on Bond Mutual Funds

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Like stock mutual funds, bond mutual funds have risks and can make or lose money. Several types of risk, including interest rate risk, can affect the price at which the individual bonds in a bond fund's portfolio trade.

Bond prices are closely related to interest rates. Bond prices and interest rates move in opposite directions. When interest rates go up, bond prices go down. When interest rates go down, the bond prices go up.

Listen to Institute President Matthew P. Fink Discuss Bond Funds and Interest Rate Risk

Text of sound bite:

Consider the example of an investor who buys a \$10,000 Treasury bond that pays 5 percent interest and matures in 10 years. If within the year interest rates rise and new 10-year bonds are issued with 6 percent interest, the price investors are willing to pay for bonds paying only 5 percent will be less than what they are willing to pay for a 6 percent bond. With current interest rates near historic lows, it is reasonable to assume that the risk of a decline in bond prices due to a rise in interest rates has increased.

The longer a bond's maturity, the more its price tends to fluctuate as market interest rates change. For example, a rise in interest rates will cause a larger drop in price for a 20-year bond than for an otherwise equivalent 10-year bond. However, while longer-term bonds tend to fluctuate in value more than shorter-term bonds, they also tend to have higher yields to compensate for this risk. In general, the longer a fund's average portfolio maturity, the more sensitive the fund's share price will be to changes to interest rates and the more the fund's shares will fluctuate in value.

When Interest Rates Rise, Bond Prices Fall

Percentage Change in Intermediate U.S. Government Bond Prices, 1979-2002

The chart below shows the effect of interest rates on bond prices. Shaded areas of the chart represent periods of rising interest rates.

Sources: Federal Reserve Board and Bloomberg

For More Information

The Institute's Investor Awareness Series helps investors establish realistic expectations about stocks, bonds, and other securities, and stresses the need for investment diversification.

[A Guide to Bond Mutual Funds](#), ICI Investor Awareness Series

[A Guide to Understanding Mutual Funds](#), ICI Investor Awareness Series

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