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What happens to the value of a bond when interest rates rise 1%?
The simple answer is prices go down.
And if you understand that key principal -- when interest rates go up, bond prices go down – you will know more than most people when it comes to bonds.
This example looks at a series of $1,000 bonds, each earning 6 percent.
If interest rates rise by 1 percent, the market value of a two-year $1,000 bond will fall to $982.
The market value of a 5-year $1,000 bond falls to $959.
And the market value of a 20-year $1,000 bond falls to $894.
Keep in mind this price volatility applies only if you decide to sell your bond holdings before they mature.
If you hold the bonds to maturity, you'll receive the interest payments due – barring default, of course – and then receive your $1,000 principal.
This example does not represent any specific investment.
But as you can see, interest rate changes are a key principal to understand.
Now let's look at the value of a bond when interest rates fall 1%.
As before, this example looks at a series of $1,000 bonds, each earning 6 percent.
If interest rates fall by 1 percent, the market value of a 2-year $1,000 bond will rise to $1,019.
The longer the term of the bond, the more pronounced this effect becomes.
The market value of a 5-year $1,000 bond increases to $1,043.
And the market value of a 20-year $1,000 bond rises to $1,125.
This price volatility applies only if you decide to sell your bond holdings before they mature.
If you hold the bonds to maturity, you'll receive the interest payments due – barring default, of course – and then receive your $1,000 principal.
Remember, interest rates will adjust as the economy continues to expand and contract.
And rates are expected to change in the months ahead which will influence bond prices.
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