Don’t be shy, ask ii…what are the alternatives to bonds?

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Don’t be shy, ask ii…what are the alternatives to bonds?. No question is a stupid one, so whether you want to find out what you need to do to start investing or how the stock market works, don’t be shy, ask ii.

Jeremy Hawkins asks: I took some profits at the end of last year and, as I am only a few years away from retirement, I am looking for a relatively safe haven – more about capital preservation than capital growth for this segment of my investment portfolio. Given the reported challenges with bonds, what other options are there?

Kyle Caldwell, Collectives Editor, interactive investor, says: As you’ve mentioned, the outlook for bonds does look challenging. Government bond yields are at historic lows, meaning they have become unattractive for income investors. Bond prices, on the other hand, have performed strongly since the financial crisis, benefiting from loose monetary policy – low interest rates and quantitative easing. Bond yields and bond prices have an inverse relationship.

If government bond yields were to rise, which they have been of late in response to rising inflation expectations, bond prices will fall. This results in capital losses for investors.

But this does not mean that bonds should be entirely avoided. Some bonds are less sensitive to the prospect of higher inflation and, down the road, potential increases in interest rates. Global and strategic bond funds are best placed to navigate the trickier environment for bonds. These funds have the flexibility to invest in different types of bonds, shifting exposure between government bonds, investment-grade corporate bonds and high-yield bonds. In interactive investor’s Super 60 list of rated funds, flexible bond options include M&G Global Macro Bond, Jupiter Strategic Bond and Marlborough Global Bond.

For those who want a more diversified approach, multi-asset funds are worth considering. Funds in the Investment Association's Mixed Investment 0-35% Shares Sector have the least amount of exposure to shares, although this does of course carry extra risk, with the balance mainly invested in bonds.

There are also a small number of wealth preservation investment trusts, which prioritise protecting investor capital and invest on the principle that they would sooner keep £1 than risk losing it to try and win £2.

The four trusts that meet this description are Capital Gearing (LSE:CGT), RIT Capital Partners (LSE:RCP), Ruffer Investment Company (LSE:RICA) and Personal Assets (LSE:PNL). Each has a low weighting to equities and plenty of defensive armoury, such as low-risk inflation-linked bonds and a small weighting to gold.

Capital Gearing is a member of interactive investor's Super 60 list. It is a multi-asset portfolio of bonds, equities and property, with small holdings in infrastructure, gold and cash. The trust has been managed by highly regarded investor Peter Spiller since 1982.

Under Spiller's long tenure, the trust has delivered positive total returns in 38 out of 39 years. The trust has also been a great preserver of wealth in bear markets, including the dot-com crash, global financial crisis and, most recently, during market slumps in both 2018 and 2020.

Other asset classes may be considered as candidates to be bond substitutes. Like bonds, both property and infrastructure have historically had little correlation with the stock market. As part of a diversified portfolio, both can help to reduce risk and generate income.

Property options include Real Estate Investment Trusts (REITs). There are two types of REIT: those that operate as property trading companies and those that operate as funds. REITs that operate as funds do not engage in development activities. BMO Commercial Property Trust (LSE:BCPT), on of interactive investor's Super 60 funds, is an example of a REIT that operates as a fund.