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Financial Briefs

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Varying Your Bond Strategies

A common misconception regarding bonds is that they are only appropriate for older or more conservative investors. However, bonds should be considered by all investors as part of a well-diversified portfolio, even though their role may change over your lifetime.

Your 20s and 30s

At this stage in your life, your investment goal is probably to maximize your capital. Your time horizon is very long, and your risk tolerance is probably high. Often, stocks will comprise a significant portion of your portfolio, but you should also consider bonds to diversify your portfolio and balance risk and volatility. Since your risk tolerance is high, you might consider higher-risk bonds, such as high-yield bonds. (High-yield bonds, also known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher-rated bonds.) If your investments in your employer's 401(k) plan or other retirement plan are heavily weighted in stocks, you might want to increase your bond allocation in your taxable portfolio.

No matter how you decide to invest, now is a great time to get in the habit of investing regularly by starting a dollar cost averaging program. Dollar cost averaging involves investing a set amount of money in the same investment on a periodic basis. For instance, instead of investing a lump sum in one stock immediately, you might invest $2,000 in that stock at the beginning of each month. A dollar cost averaging program is by definition a long-term program. Thus, if followed consistently, it helps encourage long-term investing. Dollar cost averaging, however, does not ensure a profit or protect against loss in declining markets. Before starting a dollar cost averaging program, consider your financial ability to continue purchases through periods of low price levels.

Your 30s and 40s

Your investment goal at this point in your life is probably to grow your capital. Your investment time horizon is still long, but your risk tolerance may be more moderate. During these years, you'll

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Dealing with Bond Price Fluctuations

There are two primary factors that affect bond prices — interest rate changes and credit rating changes. Interest rate changes typically will cause a bond's value to fluctuate more than credit rating changes.

As interest rates rise, a bond's price adjusts down, while the bond's price will increase when rates decrease. Simply put, bond prices and interest rates move in opposite directions. Also, bonds with longer maturity dates are more vulnerable to interest rate changes, since the difference will impact the bond for a longer time period. One of the reasons longer-term bonds typically pay higher interest rates is because there is more risk that interest rates will change during the bond's life.

Credit ratings also influence a bond's price. When a bond is issued, rating agencies assign a rating to give investors an indication of the bond's investment quality and relative risk of default. Typically, higher-rated bonds pay a lower interest rate than lower-rated bonds. After the bond is issued, the rating agencies continue to monitor it, making changes if warranted. A bond's price tends to decline when a rating is downgraded and increase when a rating is upgraded. The price change brings the bond's yield in line with other bonds with similar ratings. However, these price changes are typically minor if the rating changes by only one notch. Certain downgrades are more significant, such as a downgrade that moves a bond from an investment-grade to a speculative rating, a downgrade of more than one notch,

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How to Increase Your Bond Returns

Interest rates have been decreasing in response to the lowering of the target federal funds rate by the Federal Reserve. That, of course, is the point. The Federal Reserve hopes that with lower interest rates, individuals and companies will borrow and spend money, giving the economy a needed boost. But while lower interest rates are good for borrowers, they're not so great for investors. As rates on bonds fall, what's an investor to do?

Broadly speaking, investors can find higher yields on bond investments in two places — lower-quality bonds and longer-maturity bonds.

Lower-quality bonds

Lower quality doesn't necessarily mean low quality. There are a number of bond types that are relatively safe but offer higher yields than U.S. Treasury securities, typically considered the safest bonds. However, keep in mind that as potential yield increases, typically so does risk. From the safest, lowest yield to the riskiest, highest potential yield, there are five broad types of bonds:

- U.S. Treasury bills, notes, and bonds
- Municipal bonds
- Government agency bonds, including those issued by the Government National Mortgage Association (Ginnie Mae), Federal National Mortgage Association (Fannie Mae), and Federal Home Loan Mortgage Corporation (Freddie Mac)
- Investment-grade corporate bonds
- Noninvestment-grade corporate bonds

Corporate bonds offer the highest potential yield, but also tend to carry the most risk. But within each broad bond category (investment grade and noninvestment grade), there are a range of bond ratings.

Longer-maturity bonds

Another yield boosting option is to invest in bonds with longer maturities. Bonds with longer maturities typically have higher returns than bonds with shorter maturities, which can increase your bond portfolio's income. However, with interest rates at low levels, you need to consider how your bond portfolio would be affected by increasing interest rates, since bond values decrease when interest rates rise. Thus, you may not want to extend maturities too much or your bond's value may decrease substantially when interest rates rise. Looking at the yield curve can also help when making decisions about maturity dates. It's not unusual for a yield curve to be upward sloping for several years and then to flatten out at the longer maturities. The yield curve can help you determine whether you are gaining enough additional return when lengthening maturity dates.

Bond ladders

You can control your risk by investing in bonds with a range of maturities, using a bond ladder to structure your portfolio. Buy bonds of equal amounts at a number of maturities. As your bonds mature, invest the proceeds in the longest maturity bond in your portfolio. That way, you always keep the same average maturity in your bond portfolio. By spreading out maturity dates, you lessen the impact of interest changes.

Whether you're comfortable investing in a range of relatively safe bonds, such as Treasury securities and municipal bonds, or you prefer higher-yield bonds, you want to make sure that you're adequately compensated for your level of risk. Please call if you'd like to evaluate your bond portfolio.

Bond Strategies

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typically accumulate a significant portion of your retirement portfolio. As your children's college educations and your own retirement get closer, you will probably feel less comfortable with the possibility that your investment portfolio could decline substantially, which is why your risk tolerance is moderate. At this point, you may want to shift more of your investment portfolio to bonds. You may want to consider zero-coupon bonds, with maturities that coincide with your children's college educations. If you find yourself in a high tax bracket, you might want to take a look at municipal bonds, since the interest income is exempt from federal, and sometimes state and local, income taxes.

Your 50s and 60s

Now, your investment goal is probably to conserve capital. Your investment time horizon is moderate, while your risk tolerance is lower. With retirement getting close, you don't want to risk a major decline in your investment portfolio, so your risk tolerance is low. Bonds will probably take on increasing importance in your portfolio at this stage of life. You'll want to make sure you have a well-diversified portfolio of bonds, probably setting up a bond ladder to manage interest rate risk. Municipal bonds will probably still be of interest if you remain in a high tax bracket.

Investing after retirement

At retirement, your primary investment goal is to preserve your capital. Your investment time horizon will depend on when you will use your investments, but your risk tolerance is probably low. Many retirees like to use the steady income from bonds as a source of regular retirement income. Inflation is also a concern, so you may want to consider Treasury Inflation Protection Securities (TIPS).

Please call if you'd like to discuss what role bonds should play in your portfolio.

Bond Price Fluctuations

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or a series of downgrades over a short period of time. In those situations, you should review whether you want to continue to hold the bond.

If you want to minimize the risk of price fluctuations, consider these tips:

- If you hold a bond to maturity, you receive the full principal value, so you won't be affected by any price fluctuations. Thus, consider purchasing bonds with maturity dates that match when you will need your principal.
- Consider investing in bonds with shorter-term maturities, which are less susceptible to interest rate changes.
- Design your bond portfolio using a ladder, so you'll have bonds coming due every year or so. This strategy typically lessens the effects of interest rate changes. Since the bonds are held to maturity, changing interest rates won't result in a gain or loss from a sale. Bonds are maturing every year or two, so your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal coming due every year or so to reinvest at higher rates. In a declining interest rate environment, you have some funds in longer-term bonds with higher interest rates. A bond ladder keeps your bond portfolio invested in a range of maturity dates, evening out your interest income over time.
- Choose bonds that match your risk tolerance. Safer bonds, such as U.S. Treasury bonds or investment-grade corporate bonds, are less susceptible to credit rating risks.

Please call if you'd like to discuss this topic in more detail.

Using Bond Swaps as an Active Investment Strategy

A passive approach to bond investing typically involves purchasing a bond and holding it to maturity. With that approach, you receive your entire bond principal and do not have to worry about the effects of interest rate changes on the price of your bond. However, as the interest rate environment changes, there may be opportunities to use more active strategies for your bond investments, such as bond swaps.

A bond swap is simply the sale of one bond and the purchase of another, designed to better meet your investment objectives or to take advantage of current market or tax conditions. Some of the more common swaps include:

- A **rate anticipation swap** is made to take advantage of changes in market interest rates. It typically involves swapping short- for long-term bonds or vice versa, depending on your beliefs about the future direction of interest rates. If you anticipate interest rates will increase, you might swap out of longer-term bonds into shorter-term bonds. Then, when interest rates increase, your bonds won't be significantly affected by the rate change, and you will have funds available to invest at higher rates. If you anticipate lower interest rates, you would do the opposite to lock in current rates.
- A **substitution swap** involves swapping one bond for another similar bond with higher yields. That could happen if a company's financial situation has improved, but the bond's credit rating hasn't been upgraded yet.
- An **intermarket swap** involves swapping bonds in different market sectors, such as government and corporate, to take advantage of changing yield spreads. For instance, the spread between corporate and municipal bonds may narrow, making the returns on municipal bonds higher than corporate bonds on a tax-equivalent basis.
- A **tax swap** is made to realize a bond's loss for tax purposes. You sell bonds with a current market value less than your purchase price so you can realize the loss and deduct it on your tax return. You then use the proceeds to purchase a similar bond. The end result is you own a comparable bond, but you also have a tax loss to deduct on your tax return. That loss can be used to offset other capital gains or to offset up to $3,000 of ordinary income in excess of gains, with any excess losses carried forward to future years.

When making a tax swap, you must comply with the wash sale rules. A wash sale occurs when an investor sells a security at a loss and 30 days before or after the sale purchases a substantially identical security. If deemed a wash sale, the loss cannot be deducted for tax purposes. If you want to purchase another bond within the 30-day window, the new bond must differ in a material way from the bond sold, such as different issuers, coupon rates, or maturity dates.

Please call if you'd like help deciding whether a bond swap is appropriate for your bond portfolio.

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Business Data

Indicator	Mar-08	Apr-08	May-08	Dec-07	May-07
	Month-end				
Prime rate	5.25	5.00	5.00	7.25	8.25
3-month T-bill yield	1.44	1.42	1.87	3.28	4.86
10-year T-note yield	3.39	3.67	3.84	4.12	4.74
20-year T-bond yield	4.22	4.44	4.56	4.58	4.97
Dow Jones Corp.	5.80	5.80	5.81	5.89	5.84
GDP (adj. annual rate)#	+4.90	+0.60	+0.90	+0.60	+0.60

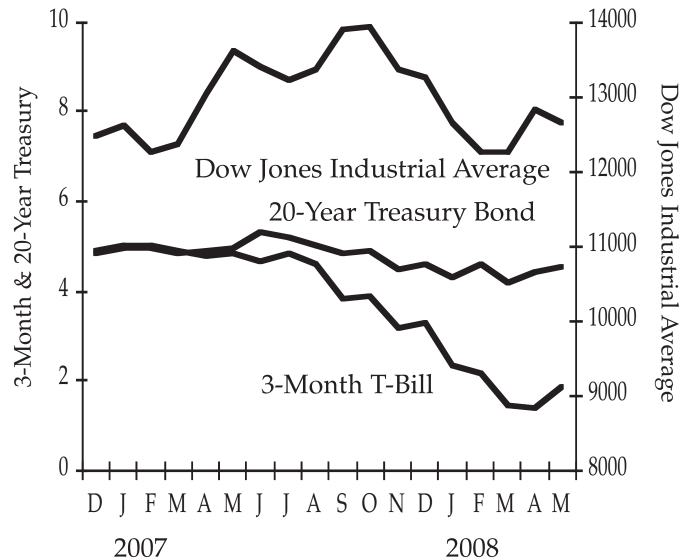
Indicator	Month-end			% Change	
	Mar-08	Apr-08	May-08	YTD	12-Mon.
Dow Jones Industrials	12262.89	12820.13	12638.32	-4.7%	-7.3%
Standard & Poor's 500	1322.70	1385.59	1400.38	-4.6%	-8.5%
Nasdaq Composite	2279.10	2412.80	2522.66	-4.9%	-3.1%
Gold	933.50	871.00	885.75	6.2%	34.4%
Unemployment rate@	4.80	5.10	5.00	—%	11.1%
Consumer price index@	211.70	213.50	214.80	2.3%	3.3%
Index of leading ind.@	101.90	101.90	102.00	-25.0%	-26.0%

— 3rd, 4th, 1st quarter @ — Feb, Mar, Apr

Sources: *Barron's, Wall Street Journal*

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

December 2006 to May 2008



News and Announcements

Protecting against Inflation with TIPS

Treasury Inflation Protected Securities (TIPS) were created in 1997 to provide bond investors with inflation protection by periodically adjusting the bond's face value based on the increase in the Consumer Price Index for All Urban Consumers (CPI-U). The bond's interest rate is determined at auction and does not change during the bond's life, but the principal is adjusted every six months. Thus, subsequent interest payments are based on the increased principal amount.

If the CPI-U decreases, your principal will decrease, so that your interest payments will also decrease over time. However, when the bond matures, you still receive the full principal value.

From a tax standpoint, interest income is subject to federal income taxes, but not state or local income taxes. Also, any increases in the bond's principal value is subject to federal income taxes in the year the adjustment is made, even though the funds aren't received until the bond matures. However, if the TIPS is held in a tax-advantaged account, such as a 401(k) plan or individual retirement account, income taxes are not paid until the funds are withdrawn.

To decide whether TIPS are a better alternative than other Treasury securities, calculate the difference between the yield on a 10-year TIPS and a 10-year Treasury security. As of May 27, 2008, that difference was 2.49% (Source: *Federal Reserve Statistical Release*), which is considered the breakeven rate. If inflation is higher than 2.49% over the 10-year period, the TIPS will have a higher yield than other Treasury securities. However, if inflation is lower than 2.49% over the 10-year period, the other Treasury security will have a higher yield than the TIPS.

With current inflation rates running around 3.8%, you might think that a TIPS is the better alternative. However, it is difficult to predict inflation over long time periods, so future inflation could be lower.

Please call if you'd like to discuss TIPS in more detail. FR2008-0225-0046