Bond strategies

Investing in stocks can be exciting, with the possibility of big rewards (as well as the accompanying risks). Bonds generally appeal to those who are less adventurous.

But, John Finneran, CFA, in a June 20, 2006, article ("MarketAxess: The Archipelago of Bonds?") on the Motley Fool Web site (www.fool.com), makes the point that bonds as an asset class are back, chiefly as a result of rising interest rates. For example, he notes, "there's more value in taking corporate credit risk, as credit spreads—the difference between corporate bonds and risk-free U.S. Treasuries—rise."

Bond basics

In a balanced investment portfolio, bonds may provide stability. Bond prices generally are less volatile than stock prices, and bond interest payments are generally higher than dividend payout rates. Those who need to live on their portfolio income like the predictability of bonds, and many of those who feel burned by the stock market in recent years have shifted more and more to fixed-income securities.

But bonds are not without their own risks. In particular, bond investors need to be concerned about interest rate risk. When interest rates are rising, as they have been, the prices of outstanding bonds must fall, and, conversely, as interest rates fall, bond prices go up. What's more, bonds with longer maturities generally respond more sharply to interest rate changes. That's why longer-term bonds typically offer higher interest rates than shorter-term obligations.

Purposeful diversification

In times of economic uncertainty, there is a strong temptation to park assets in the relative safety of money market funds, waiting for a better time to invest. That's not often the best approach. One problem is successfully identifying that "better" time to invest, and another is the still relatively low income being paid by money funds these days. Bond investors may turn to three strategies to increase their income while managing interest rate risk.

• *Bullets*. Let's say that you have $100,000 that will be needed in ten years to help fund a college education. A ten-year bond will lock in today's interest rates, but you will not be able to take advantage of future interest rate increases. The alternative is to spread the bond investment over time, choosing the same target maturity. Ten-year maturities

would be purchased in the first year for a portion of your fund, nine-year maturities in the second, eights in the third, and so on.

• *Barbells*. Simply to increase the yield from a bond portfolio, long- and short-term bonds may be acquired, avoiding the intermediate maturities. If the long-term bonds can be held to maturity, the investor need not worry about paper losses that occur if interest rates rise. Meanwhile, the short-term bonds can be reinvested at higher rates as they mature.

• *Ladders*. Building a laddered portfolio involves buying an assortment of bonds with maturities distributed over time. For example, you might invest equal amounts in securities maturing in two, four, six, eight and ten years. In two years, when the first bonds mature, you would reinvest the principal in a ten-year bond, maintaining the ladder. This approach provides better protection against interest rate risk than investing in a bond with a single maturity, especially a longer maturity. The ladder generally provides a greater yield than investing only in short-term issues.

To learn more about how to stabilize your portfolio income and about your investment portfolio in general, please feel free to call upon us at any time.

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Any developments occurring after January 15, 2007, are not reflected in this article.