Bond ladders

Retirees seeking a reliable source of income at an acceptable level of risk often will boost the bond portion of their portfolios. Because of today's volatile stock market, many investors are revisiting their asset allocation strategy and adjusting their portfolios to include more fixed-income investments.

Bond risks

Bondholders face three significant risks: *default risk*, *interest-rate risk,* and *reinvestment risk*. Default risk is the chance that the issuer will lose the ability to make interest or principal repayments.

When interest rates rise, the bond values decline. If rates fall, values rise. And the longer the maturity of the bond, the more volatile the price will be. Because prices fluctuate, bondholders may reap some gain or incur a loss when a bond is sold prior to its maturity date. If a bond is held to maturity, the loss on paper won't be realized.

Reinvestment risk refers to what investors may face *after* a bond reaches maturity. When a bondholder receives his or her original investment back, he or she must reinvest at prevailing interest rates. If rates have fallen since the original purchase, the investor must choose to accept less income or invest in another kind of security.

Managing risk with a bond ladder

One of the decisions that investors who are considering a bond purchase must grapple with is choosing a maturity date. Short-term bonds offer the most safety, but with their low yields may not provide a sufficient flow of income. Longer-term bonds offer more income, but the farther out an investor goes, the greater the risk that should the bond need to be cashed in prior to maturity, he or she will receive less than what was paid for the bond.

The solution for some investors is to establish a *bond ladder*. The investor decides how much he or she wants to invest in bonds and divides the amount equally, purchasing bonds with staggered maturities (each maturity date comprises a rung of the ladder).

If interest rates are trending upward right after an investor has purchased a bond, he or she knows that there will be money forthcoming in the near future to take advantage of the

higher rates when one of the shorter-term bonds mature. Conversely, if interest rates are declining after the purchase, the investor has been able to lock in the higher rates for a portion of his or her portfolio.

In addition, an investor may have the flexibility to match or adjust the flow of income according to his or her needs. And the relative liquidity can be a buffer when unexpected expenses are incurred.

For maximum safety, investors may choose Treasury bonds. For shorter maturities the ladder's rungs can be constructed with Treasury notes or bills or even CDs. Depending upon the investment strategy, ladders or rungs might consist of other securities, such as municipal or corporate bonds.

An example

Say that Investor wants to create a bond ladder with $100,000 in capital with a maximum ten-year maturity. He invests $20,000 each in Treasuries with maturities of two, four, six, eight and ten years. If Investor wishes to maintain the same average maturity for his ladder, every two years as a bond matures, it is replaced with a ten-year bond.

With this approach, Investor always has 20% of his or her bonds maturing in two years, with funds available to take advantage of higher-yielding bonds if interest rates increase or to use as a cash source should a need later arise.

Consider these points

Interest-rate risk is not eliminated with a bond ladder. Should a bond need to be sold prior to its maturity date, and interests rates are higher than at the time of its purchase, the bondholder receives less than what he or she paid for the bond. If there are callable bonds in the ladder, and they *are* called before maturity, interest payments cease, and the principal is returned to the investor as of the call date. Reinvesting the principal will mean accepting income payments that are consistent with the prevailing interest rates.

What's more, because Treasury bonds are available only in limited maturities, an investor may have to use the secondary market and buy a bond at a premium. But at maturity an investor receives only the par value of the bond. (The loss may be deducible on his or her tax return.)

Bond ladders, as with any investment strategy, are not for everyone. If you are considering increasing the allocation of bonds in your portfolio, we would be glad to evaluate your current holdings and discuss the pros and cons of a bond ladder in your particular circumstances.

Any developments occurring after January 1, 2014, are not reflected in this article.