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How to Build and Manage a Bond Portfolio

Bonds have three basic purposes in a portfolio: to diversify a stock portfolio, to maximize total return, or to generate income. Depending on your objective, there are several strategies open to you.

Diversifying a Stock Portfolio

Adding bonds to a stock portfolio is one of the main ways to reduce investment risk. Bonds accomplish this because their performance cycle is generally out of sync with the ups and downs of the stock market. In years when stocks are performing poorly with weak or negative returns, bonds may be outperforming stocks.

In fact, that was the case in six out of the last 13 years. In three of those years, bonds (as represented by the Barclays Aggregate Index) were the top-performing asset class; and in two of the years, bonds achieved returns that exceeded the long-time average of 10% for S&P 500 stocks. Looking into the previous decade, in 1995, bonds returned 18.5% and twice returned more than 9%. Meanwhile, bonds lost money for investors only twice in the last 20 years (-2.9% in 1994 and -0.8% in 1999), while stocks lost money in four years, with losses ranging from -9.1% to -37.0% (Source: Callan Associates, Inc., 2013). *These returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment vehicle. Historical returns are not indicative of future returns.*

Professional money managers measure risk by a statistical value called "standard deviation," expressed as a percentage. Over the last 10 years, stocks returned a compound average annual return of 5.4% and were characterized by a standard deviation of 18.3%. Meanwhile, bonds returned an average of 4.0% with a standard deviation of 1.6%. That means that as an asset class, bonds generated nearly 80% of the return of stocks, but with less than one-tenth of the risk.

By adding bonds to an all-stock portfolio over the last 10 years, an investor could have potentially

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Is Your 401(k) Plan Enough?

According to the Employee Benefits Research Institute, the average 401(k) plan balance at the end of 2010 was just $60,000. The average participant contributed just $6,750 in 2011, with another $3,270 in matching contributions from his/her employer (Source: Vanguard, 2012). These numbers may sound robust until you consider the following:

- Based on 2011 median household income ($50,000), the average American will need $30,000 to $40,000 in annual retirement income (60% to 80% of preretirement income).
- Social Security provides, on average, about 40% of preretirement income, or about $20,000 for the median household, leaving a gap of $10,000 to $20,000 to be filled from personal savings (Source: Center for Retirement Research, 2012).
- At an annual withdrawal rate of 4%, the average 401(k) balance of $60,000 will provide only $2,400 of that gap. If it's used to fill the entire income gap, those 401(k) assets would be depleted in far fewer than the 15 to 20 years the average American spends in retirement.

A closer look at those Americans

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How to Build

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achieved close to the same returns of the stock market with much less risk. Again, using the returns from the two indexes, a portfolio comprising 60% stocks and 40% bonds would have generated nearly all of the return of an all-stock portfolio — 5.2% versus 5.4% — with 40% less risk (10.9% versus 18.3%).

When your goal is to reduce the risk of your overall investment portfolio, it's important to buy high-quality bond issues and avoid investing mainly in long maturities. Low-quality bonds and bonds with long maturities may offer higher yields, but both expose you to greater risk.

Maximizing Total Return

When you want to generate a high total return over the long term, your bond objective is to generate capital gains, which you do by trading — buying and selling bonds before they mature — and reinvesting the proceeds in more bonds. Professional money managers do this in two ways: buying discount bonds and concentrating purchases of bonds in one or more specific maturities.

The prices of existing bonds change as market interest rates rise or fall. When interest rates rise, the prices of existing bonds generally go down, sometimes below their face value. Bonds priced below that benchmark are called "discount bonds." If an investor buys a discount bond and holds it to maturity at face value, the result is a profit.

Sometimes, similar price advantages emerge among bonds at specific maturities because of inefficiencies in the bond market. Professionals know that there is a pattern to the line that connects yields and maturities, known as the "yield curve." Irregularities can develop in the yield curve that suggest to professionals that prices at a specific maturity are temporarily depressed. While not actual "discount bonds," the prices of these bonds are expected to increase as the yield curve returns to its normal shape.

Generating Income

When you're positioning your portfolio, you should concern yourself with maximizing your total return in light of your tolerance for risk. But once you're retired, many people hold bonds to generate income to support their lifestyle instead of reinvesting the interest. While any portfolio structure will suffice, a "laddered" bond portfolio is often recommended.

To create a ladder, divide the total amount of capital you want to devote to generating income into five to 10 equal parts. Then, invest each amount in bonds of different maturities; and when your shortest-maturity bonds mature, reinvest the proceeds in the bonds with the longest maturity you started with.

A bond ladder's chief advantage is to keep the interest income you receive more even over the years than it would typically be if all of your bonds mature at the same time. When all of your bonds mature, how much income you generate depends on the rates that prevail at the time.

Your stage in life, your risk tolerance, and your needs for income or total return are all important factors in the structure of the bond portfolio that's right for you. Please call to discuss this in more detail. ❍❍❍

Are All Triple-A Ratings Alike?

Unlike stock investors, those who invest in bonds usually have a way to gauge how risky an investment might be. It's the rating assigned to the bond by a credit rating agency, with triple-A being the agency's best rating. However, not every triple-A rating means precisely the same thing. Here's why:

❍ **The ratings are relative to the sector.** The three major bond sectors each present different levels of risk completely apart from the ratings each bond carries. In general, from the safest to the riskiest, the bond sectors are Treasuries, municipals, and corporates. Ratings agencies use the same scale for every sector.

❍ **Ratings are opinions.** Financial ratings are opinions and, as such, are as much art as science. Ratings are based on a careful review of the numbers, and each rating agency has its own general guidelines; but opinions can vary not only between credit agencies, but even between different analysts.

❍ **The issuers pay for ratings.** The rating agencies make their money from the fees they charge bond issuers. Ostensibly, the agencies are able to command the respect of the marketplace by remaining objective.

❍ **Things change.** Our global economic and financial systems are incredibly fast-changing. Credit downgrades and upgrades are quite common, but with tens of thousands of bond issuers, the agencies can't keep up real time with changes in every issuer's circumstances.

❍ **Bond insurance can mask problems.** It's not uncommon for issuers of municipal bonds to secure bond insurance. In that case, the bonds assume the credit rating of the bond insurance company, regardless of the state of the issuer's finances. If times got tough for state and city governments and a large number of them were to get financially weaker, it may be beyond the wherewithal of the municipal bond insurance industry to make every bond investor whole, in spite of its high rating. ❍❍❍

Is Your 401(k)?

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within 10 years of retirement reveals a slightly better picture. When you add in IRA assets — often rolled over from prior employers' 401(k) plans — Americans age 55 to 64 years have total retirement assets of $120,000, according to the Center for Retirement Research at Boston College. But that still leaves the average American far short of the personal assets needed for retirement.

Contributions and Returns Matter

Despite the inadequacy of most Americans' 401(k) assets, the rules that govern the plans do make it possible to have what you need for a comfortable retirement. To do that, however, you should contribute close to the maximum allowable for as long as you work and earn at least a moderate rate of investment return.

The maximum allowable contribution to a 401(k) plan rose to $17,500 in 2013. In addition, if you're 50 years old or older, you can make an additional catch-up contribution of another $5,500.

But, who today saves the maximum allowed by law? The Center for Retirement Research estimates that in 2010, just under 7% of those who earn $40,000 to $60,000 a year contribute the maximum, while 28% of those who make $100,000 a year or more do.

What You Need to Do

For those who have to rely on what they save, the answer is to maximize their 401(k) contribution limits and, if possible, save more by contributing to an IRA both for yourself and your spouse.

In addition, it's important to adjust your investment strategy so that you obtain a reasonable average rate of return that exceeds the inflation rate by a comfortable amount.

One key is finding ways to increase the amount you save every year. The other is avoiding years of deep investment losses while finding niches of opportunity to stay ahead of inflation. Please call if you'd like to discuss this in more detail. ❍❍❍

Long-Term Portfolio Management

Are you an investor or a trader? If you're a trader looking to build your wealth through a long series of profitable short-term transactions, then knowing what the indicators are showing month-to-month can be critical to your success.

On the other hand, if you're in the markets for the long haul and looking to capture the benefits of long-term trends in the markets, you should focus on the tools that maximize your long-term rate of return while managing the risks you take to get it.

The following basic tools for long-term portfolio management minimize information overload while resting on some simple but effective concepts:

Asset allocation. A long-term asset allocation strategy aims at determining an optimal mix of potential asset classes, including stocks, bonds, and cash for illustration, in your portfolio to suit how much risk you're willing to take for the potential rate of return you want and need to meet your objectives. The benefit of investing in all three illustrated asset classes is diversification — spreading investments among assets that have different cycles of return.

Portfolio rebalancing. The technique is relatively simple: once a year (or some other predetermined time period), compare the percentage of your assets in each class to your strategy. Then sell some assets from the categories that are larger than your strategy calls for and use the proceeds to buy more of the assets that decreased in value. The principle is that rebalancing forces you to sell high and buy low.

Dollar cost averaging. This technique actually puts market downturns to work in your favor. The method is to invest a set amount of money on a recurring basis in each asset class. By continuing to make purchases when prices decline, you buy more shares than you do when prices are high. *Keep in mind that dollar cost averaging neither guarantees a profit nor protects against loss in a prolonged declining market. Because dollar cost averaging involves continuous investment regardless of fluctuating price levels, investors should carefully consider their financial ability to continue investment through periods of low prices.*

Between the strategies of trading actively and managing your portfolio strictly for the long term is a technique called "tactical asset allocation." This involves moving significant chunks of your portfolio from one asset class to another, depending upon your reading of the changing prospects for risk and reward in each asset class.

Trading involves market timing, which in turn, depends on reading market and economic indicators with precision. It can be thrilling, but it's also very difficult to do well.

To determine the approach that's right for you, please call. ❍❍❍

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Financial Data

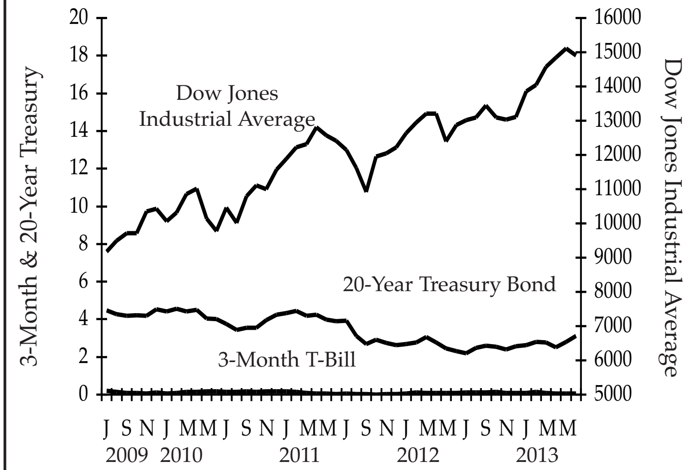
Indicator	Month-end Apr-13	May-13	Jun-13	Dec-12	Jun-12
Prime rate	3.25	3.25	3.25	3.25	3.25
Money market rate	0.47	0.46	0.45	0.51	0.50
3-month T-bill yield	0.05	0.05	0.06	0.09	0.10
20-year T-bond yield	2.51	2.80	3.11	2.56	2.32
Dow Jones Corp.	2.44	2.67	3.18	2.70	3.14
30-year fixed mortgage	2.98	3.41	3.87	2.81	2.91
GDP (adj. annual rate)#	+3.10	+0.40	+1.80	+0.40	+1.90

Indicator	Month-end Apr-13	May-13	Jun-13	% Change YTD	12 Mon.
Dow Jones Industrials	14839.80	15115.57	14909.60	13.8%	15.8%
Standard & Poor's 500	1597.57	1630.74	1606.28	12.6%	17.9%
Nasdaq Composite	3328.79	3455.91	3403.25	12.7%	16.0%
Gold	1469.00	1394.50	1192.00	-28.3%	-25.4%
Consumer price index@	232.80	232.50	232.90	1.2%	1.3%
Unemployment rate@	7.60	7.50	7.60	-2.6%	-7.3%
Index of leading ind.@	94.40	95.10	95.20	1.9%	-0.6%

— 3rd, 4th, 1st quarter @ — Mar, Apr, May Sources: *Barron's, Wall Street Journal*

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

July 2009 to June 2013



Past performance is not a guarantee of future results.

News and Announcements

Bid, Ask, and Spread

Rather than trading on organized exchanges, bonds trade in a huge over-the-counter market, consisting of networks of independent dealers. Since there is no central trading place and literally millions of issues that may only trade infrequently, pricing information for bonds is not as readily available as it is for stocks. To determine the commission you are paying to buy or sell a bond, you need to understand the significance of bid, ask, and spread.

Bond prices are quoted in pairs — the bid price is the bond's selling price and the ask price is the bond's purchase price. The bid price will be lower than the ask price, with the difference between the two representing the spread, or commission. Prices quoted in papers are market prices, while prices quoted to individual investors are often wider than those prices.

Commissions can vary for a variety of reasons, including the bond's size, the type of bond, the bond's maturity date, the bond's credit quality, the direction of interest rates, demand for a specific bond, and the dealer's cost and markup. As a general rule, lower-risk bonds that are in high demand have lower commissions, while higher-risk bonds with less demand have higher commissions. Typically, commissions can range from ½% to 1% for actively traded Treasury securities to as much as 4% for inactively traded bonds.

Determine the spread before purchasing a bond. If you are purchasing a bond that you may need to sell before maturity, be cautious of a bond with a large commission. You may find that you have trouble selling the bond, and you could pay another high commission when selling.

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