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The Bulldog Bulletin

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Managing Bond Risks

All investments are subject to risk, although the types of risk can vary. While you can't totally eliminate those risks, you can develop strategies to minimize them. For bonds, consider these strategies:

Interest rate risk — Interest rates and bond prices move in opposite directions. A bond's price will rise when interest rates fall and decrease when interest rates rise. This occurs because the existing bond's price must change to provide the same return as an equivalent, newly issued bond paying prevailing interest rates. The longer the bond's maturity, the greater the impact of interest rate changes. Also, the effects of interest rate changes tend to be less significant for bonds with higher-coupon interest rates.

To reduce this risk, consider holding the bond to maturity. This eliminates the impact of interest rate changes, since the total principal value will be paid at maturity. Thus, selecting a maturity date that coincides with your cash needs will help reduce interest rate risk. However, you may still receive an interest income stream that is lower than current rates. Selecting shorter maturities or using a bond ladder can also help with this risk.

Reinvestment risk — You typically know what interest income you will receive from a bond, but you must then take the periodic income and reinvest it, usually at varying interest rates. Your principal may also mature at a time when interest rates are low.

Staggering maturities over a period of time (laddering) can lessen reinvestment risk. Since the bonds in your ladder mature every year or so, you reinvest principal over a period of time instead of in one lump sum. You may also want to consider zero-coupon bonds, which sell at a deep discount from par value. The bond's interest rate is locked in at purchase, but no interest is paid until maturity. Thus, you don't have to deal with reinvestment risk for interest payments, since you don't receive the interest until your principal matures.

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Are U.S. Treasury Bonds Still Safe?

Since 1917, U.S. Treasury securities always held the very highest rating from credit rating agencies. That is, until August 5, 2011, when Standard & Poor's stripped Treasury bonds of their triple-A rating and replaced it with their second-best rating.

What did the downgrade to double-A mean to the world's bond investors? Not much. In fact, they reacted as if Treasury bonds had just received an upgrade. That very same day, a bull market in Treasury bonds began that lowered the yield on 10-year Treasury notes from 2.58% the day before to 2.24% by the end of the next week, and hit a record intraday low of 1.6963% in September. Even now, the yield is hovering around 2%, well below its average of 4.67% since 1881.

So here's the short answer to the question "Are U.S. Treasury bonds still safe?": in absolute terms, yes, U.S. Treasury bonds are still safe. Even according to S&P itself, the difference between the highest and second-best ratings is very small. S&P says a triple-A rating reflects its opinion that a bond issue has "extremely strong capacity to meet [its] financial commitments," while a double-A score means it has a "very strong capacity."

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Bond Risks

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Inflation risk — Since bonds typically pay a fixed amount of interest and principal, the purchasing power of those payments decreases due to inflation, which is a major risk for intermediate- and long-term bonds.

Investing in short-term bonds reduces inflation's impact, since you are frequently reinvesting at prevailing interest rates. You can also consider inflation-indexed securities issued by the U.S. government, which pay a real rate of return above inflation.

Default and credit risk — Default risk is the risk the issuer will not be able to pay the interest and/or principal. Credit risk is the risk the issuer's credit rating will be downgraded, which would probably decrease the bond's value.

To minimize this risk, consider purchasing U.S. government bonds or bonds with investment-grade ratings. Continue to monitor the credit ratings of any bonds purchased.

Call risk — Call provisions allow bond issuers to replace high-coupon bonds with lower-coupon bonds when interest rates decrease. Since call provisions are generally only exercised when interest rates decrease, you are forced to reinvest principal at lower interest rates.

U.S. government securities do not have call provisions, while most corporate and municipal bonds do. Review the call provisions before purchase to select those most favorable to you.

Keep in mind that the assumption of risk is generally rewarded with higher return potential. One of the safest bond strategies is to only purchase three-month Treasury bills, but this typically results in the lowest return. To increase your return, decide which risks you are comfortable assuming and then implement a corresponding bond strategy. Please call if you'd like help with your bond investing strategy. ❍❍❍

Encourage Your Child to Fund an IRA

Once your child starts working, help him/her develop good savings habits by encouraging him/her to fund an individual retirement account (IRA). Even if your child only contributes for a few years, an IRA can provide significant funds for retirement.

Your child must have earned income to contribute to an IRA and may only contribute the lesser of earned income or the maximum IRA contribution. The maximum limit is $5,000 in 2012.

Assume your 16-year-old daughter starts working part-time. If she contributes $2,000 to an IRA from the ages of 16 to 22, she will contribute $14,000 over seven years. With no further contributions, the IRA could potentially grow to $527,437 on a tax-deferred or tax-free basis by age 65. That assumes earnings of 8% compounded annually, but does not include any income taxes that might be due.

If your child continues annual $2,000 IRA contributions until age 65, she would make total contributions of $98,000 and could accumulate investments of $1,145,540. (*These examples are provided for illustrative purposes only and are not intended to project the performance of a specific investment vehicle.*)

Although most children will be eligible to contribute to both a traditional deductible IRA and a Roth IRA, you should probably encourage your child to fund a Roth IRA, which has several advantages:

- **Roth IRAs are more flexible.** Your child can withdraw all or part of his/her contributions at any time, without paying federal income taxes or penalties. Thus, if your child later decides to use contributions for college, a car, a down payment on a home, or for some other purpose, contributions can be withdrawn with no tax consequences.
- **Earnings accumulate tax free, plus qualified distributions can be withdrawn tax free.** A qualified distribution is one made at least five years after the first contribution and after age 59½. There are also certain circumstances where earnings can be withdrawn without paying income taxes and/or the 10% federal income tax penalty. If your child allows the funds to grow until at least age 59½, all contributions and earnings can be withdrawn without paying any federal income taxes.
- **A traditional deductible IRA offers little tax benefit to a child.** When your child first starts working, he/she will typically pay a low marginal tax rate on his/her income. So even though the Roth IRA contribution is not tax deductible, your child typically receives little or no tax benefit from deducting the traditional IRA contribution anyway.

If you can't convince your child to use his/her own money to fund the IRA, consider reimbursing him/her as part of your annual gift tax exclusion for any IRA contributions. Hopefully, you will also teach your child some important lessons about saving at an early age. Please call if you'd like to discuss how to implement this strategy for your child or grandchild. ❍❍❍

Are U.S. Treasury?

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Furthermore, the other big rating agencies, like Moody's and Fitch, stood by their best scores for Treasury bonds, although both issued warnings that they might downgrade them. A spokesman for Moody's said a downgrade might come within two years. Meanwhile at Fitch, an executive said that a rating cut might come in the "medium term," but that the risks for a near-term downgrade "are not high."

Federal Budget Woes in Perspective

The Treasury rating hubbub reflected a growing concern over the size and growth of America's federal debt, Congress' brinksmanship last summer over the federal debt ceiling, and whether to withhold funding for government operations — including debt service payments — over a commitment to reducing government spending.

In the context of the European sovereign debt crisis and continuing weakness in the U.S. and global economies, debt-related concerns have spooked many investors. U.S. federal debt stands at more than $15 trillion, a record high, and has more than doubled since 2001. More significantly, federal indebtedness now stands at 102% of gross domestic product (GDP), a level not seen since the end of World War II, when it reached a high of 122% in 1946.

The fear is that the United States will become "the next Greece," where sovereign debt stands at more than 140% of GDP, or the "next Italy," where the ratio is nearly 120%. Both countries face the prospects of severe cutbacks in government spending in order to remain solvent, but the cost may be an even deeper recession.

The U.S. Economy Holds the Key

Economists point out that there are big differences between the U.S. and countries like Greece and Italy. For one thing, U.S. interest rates are much lower: the yield on 10-year Treasury bonds is around 2%, compared to 7.5% on Italian 10-year government bonds and more than 37% on Greek bonds. That means that there is considerably less pressure on the U.S. Treasury to keep up with its interest payments than in either of those troubled governments.

Economists point out that the key to resolving America's debt problem is a stronger economy, and there are some recent signs of that. So while the world holds its breath over whether the European debt crisis will send the global economy into another deeper recession, investors still seem to believe that U.S. Treasury bonds are among the safest place for their money. But whether *you* should purchase Treasury bonds is another matter. Please call if you'd like to discuss this in more detail. ❍❍❍

Should You Serve as a Guardian?

When asked to serve as the guardian of someone's minor children in the event of his/her death, it is usually meant as a compliment that the person trusts you to serve in this important role. While you may fear that you'll hurt your relationship with that person by saying no, don't accept this role without giving it serious thought. Consider the following:

- ❍ **Are your lifestyles compatible?** Go over all details involved in raising the children. Will the children move in with you? If so, will that mean relocating them far from their current home? It is difficult to lose parents, but it becomes even more traumatic when the children must relocate away from friends and school. What are the parents preferences regarding education, religion, lifestyle, and other factors? How well does your family get along with their children? Consider the impact on your children, including the fact that you will probably have less time available for them. Combining families is never easy, and you should consider all factors before agreeing to serve as guardian.
- ❍ **How much financial support will be available?** This involves more than making sure money is available for college and other expenses directly attributable to the children, such as clothing, medical expenses, and entertainment. Additional children in your house will increase many of your bills, including food, utilities, transportation costs, etc. Your house may now be too small, requiring an addition to your current home or moving to a larger home.
- ❍ **Are you comfortable taking on responsibility for the children's finances?** Just because you agree to take physical custody of the children does not mean you have to handle their finances. You may feel more comfortable with another person involved to review how the children's money is spent.
- ❍ **Has a contingent guardian been named?** Find out if a contingent guardian has been named in case you cannot serve. However, don't use this as an excuse to say yes when you really want to decline. It is better to indicate that you do not want to take on this responsibility now, so another guardian can be chosen and has the opportunity to go over all these details. Also, if your situation changes in the future, inform the parents immediately.

Please call if you would like to discuss the topic of serving as a guardian in more detail. ❍❍❍

Financial Data

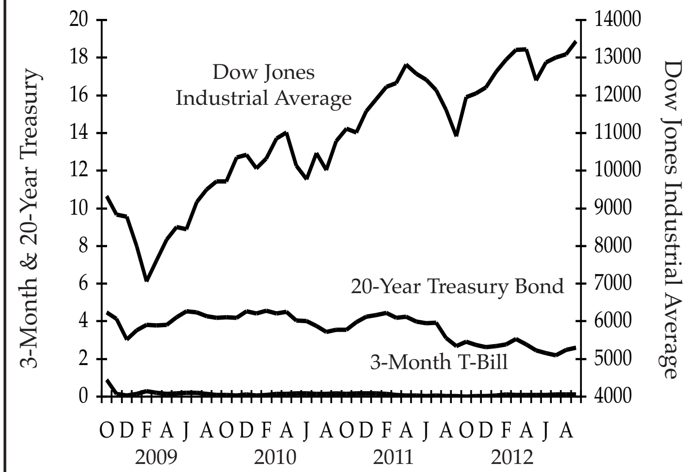
Indicator	Jul-12	Aug-12	Sep-12	Dec-11	Sep-11
	Month-end				
Prime rate	3.25	3.25	3.25	3.25	3.25
Money market rate	0.53	0.52	0.51	0.49	0.54
3-month T-bill yield	0.11	0.11	0.11	0.03	0.02
20-year T-bond yield	2.20	2.47	2.60	2.63	2.68
Dow Jones Corp.	3.14	3.04	2.72	3.74	3.69
30-year fixed mortgage	2.77	2.67	2.68	3.42	3.43
GDP (adj. annual rate)#	+3.00	+2.00	+1.30	+3.00	+1.30

	Month-end			% Change	
Indicator	Jul-12	Aug-12	Sep-12	YTD	12 Mon.
Dow Jones Industrials	13008.68	13090.84	13437.13	10.0%	23.1%
Standard & Poor's 500	1379.32	1406.58	1433.32	14.0%	26.7%
Nasdaq Composite	2939.52	3066.96	3093.70	18.8%	28.1%
Gold	1622.00	1648.50	1776.00	13.1%	9.6%
Consumer price index@	229.50	229.10	230.40	1.9%	1.7%
Unemployment rate@	8.20	8.30	8.10	-6.9%	-11.0%
Index of leading ind.@	95.40	95.80	95.70	-18.5%	-17.6%

— 4th, 1st, 2nd quarter   @ — Jun, Jul, Aug   Sources: *Barron's, Wall Street Journal*

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

October 2008 to September 2012



Past performance is not a guarantee of future results.

News and Announcements

The Costs of That Second Income

After having children, it can be difficult to decide whether both spouses should continue to work. You can't just look at the gross income generated from the second job, since a wide variety of expenses typically accompany that second income. Those expenses include:

- **Taxes** — Social Security and income taxes can take a significant chunk out of the second income. Couples are taxed on their combined income, so the second income is taxed at a higher federal rate than the first income. The second income might also push the couple into a higher tax bracket or cause some tax benefits to be lost.
- **Child care** — The cost of child care for young children can be very high. Even with school-age children, arrangements usually must be made for care after school and during school vacations.
- **Commuting** — Not only should you consider out-of-pocket transportation costs, but keep in mind that commuting keeps you away from home for a longer period. An eight-hour work day may actually mean nine or 10 hours away from home.
- **Meals** — In addition to lunches, many working people purchase breakfast as well as drinks and snacks during the day. It's also not uncommon for working couples to dine out more frequently.
- **Clothing** — Depending on the nature of the work, the second job may require significant expenditures for clothing and dry cleaning.

Once all costs are considered, you may find the second job really doesn't contribute much to the family's income. However, nonfinancial factors may also weigh in your decision. Some people value the personal fulfillment that comes from working and earning an income. Or delaying a career for even a few years may mean the spouse doesn't advance as quickly once he/she returns to work. ❍❍❍

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