

BOND ALERT



7/25/13

What Investors Should Know

This special report will help you understand the current environment for bonds and discuss how that environment may change with rising interest rates. We will also detail strategies investors may adopt to help mitigate bond risks and potentially reposition their portfolio.

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Understanding Bonds

WHAT INVESTORS SHOULD KNOW

INTRODUCTION

Bonds are generally popular with investors who are seeking income and can be an excellent addition to a well-rounded portfolio as part of a long-term financial strategy. In recent years, the Federal Reserve has aggressively sought economic growth through bond purchases and ultra-low interest rate policies. These historically low interest rates have created a bull market for bonds issued with higher stated interest rates. However, these policies will eventually come to an end, meaning bond investors need to understand the potential risks and rewards of holding bonds during a period of interest rate increases.

BOND BASICS

Bonds are essentially loans that investors make to the bond issuer, which can be a corporation, government, federal agency or other organization. As a result, bonds are frequently referred to as debt securities since they are a debt the issuer owes to its bondholders. Since investors won't lend their money without compensation, bond issuers promise bondholders interest as well as repayment of the original sum (the bond principal). Bonds are also known as fixed-income securities because many pay out interest at a rate and interval set when the bond is issued.

Investors may be attracted to bonds for several reasons, including:¹

- Their income-generating ability;
- Capital appreciation potential. Positive events (such as improvements in the credit quality of the issuer, or declining interest rates) can reward investors with increases in the market value of bonds;
- Security. If a company is liquidated, bondholders usually have priority over stockholders in a payment structure and may be more likely to receive repayment;
- Portfolio risk diversification. Bonds can help investors spread assets across different segments of the financial market, reducing their concentration in any single asset class. ²Diversification cannot eliminate risk or protect principal during periods of widespread market declines.

Like all investments, bonds offer a balance between risk and potential return. The risk that concerns most investors is the chance that they will lose some or all of the money they invest; the return is the money investors stand to make on the investment. The balance between risk and return varies based on the investment, the entity that issues the security, the state of the economy, large market

¹ "Types of Bonds." Investing in Bonds. <http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=19&id=191>

movements, and many other factors. In general, to earn higher returns, an investor must take greater risks.

Bonds are generally considered to be less risky than stocks for a few reasons:³

- Bonds carry an explicit promise to return the face value (principal) of the security to the investor at maturity.
- Most bonds promise to pay out a fixed rate of interest income to the investor. Some stocks pay dividends, but there is no explicit promise to do so.
- Historically, the bond market has been less vulnerable to price swings and volatility than the stock market.

UNDERSTANDING BOND RISKS

Bonds play an important role in many portfolios, but it's important to understand that they are subject to certain general and specific risks. While not exhaustive, here are some risks you should be aware of when investing in bonds:⁴

Reinvestment risk: When interest rates are declining, investors must reinvest any interest income and return of principal at lower rates, reducing their investment returns.

Inflation risk: Inflation causes future dollars to be worth less than today's. Since a bond's principal does not grow over time, investors risk a reduction in the purchasing power of future interest income and principal over time.

Market risk: This is the risk that the bond market will decline as a whole, bringing down the value of individual bonds, regardless of their fundamental characteristics.

Call risk: Some bonds contain a "call provision," which allows their issuers to redeem them prior to maturity, causing an investor's principal to be returned sooner than expected and making them lose out on future interest payments. Declining

Common Questions About Bond Duration

What is bond duration?

Duration is a number that measures a bond price's sensitivity to interest rates. The higher a bond's duration, the more sensitive a bond's price is to interest rate changes.

How can I find the duration of an individual bond?

A number of factors can affect a bond's duration. The simplest way to find this information is to ask your investment professional or the bond's issuer. You can also consult an online bond duration calculator.

Does low duration mean low risk?

No. Just because a bond's duration is low, it does not mean your investment is risk-free. In addition to duration risk, bonds are subject to inflation risk, call risk, default risk and other risk factors.

What affects a bond's duration?

Variables such as how much interest a bond pays during its lifespan, the bond's call or redemption features, yield, credit quality of the issuer, maturity, all play a role in duration computations.

³ "What You Should Know." Investing in Bonds. <http://www.investinginbonds.com/learnmore.asp?catid=3&id=383>

⁴ *ibid.*

interest rates may trigger the redemption of a callable bond, forcing investors to reinvest the principal at lower interest rates.

Interest rate risk: Generally, when interest rates rise, bond prices fall. Conversely, when interest rates decline, bond prices typically rise. Investors who sell bonds prior to maturity may lose some or all of their principal.

Duration risk: The sensitivity of a bond's price changes in prevailing interest rates. The higher a bond's duration, the more sensitive its price to interest rate changes.

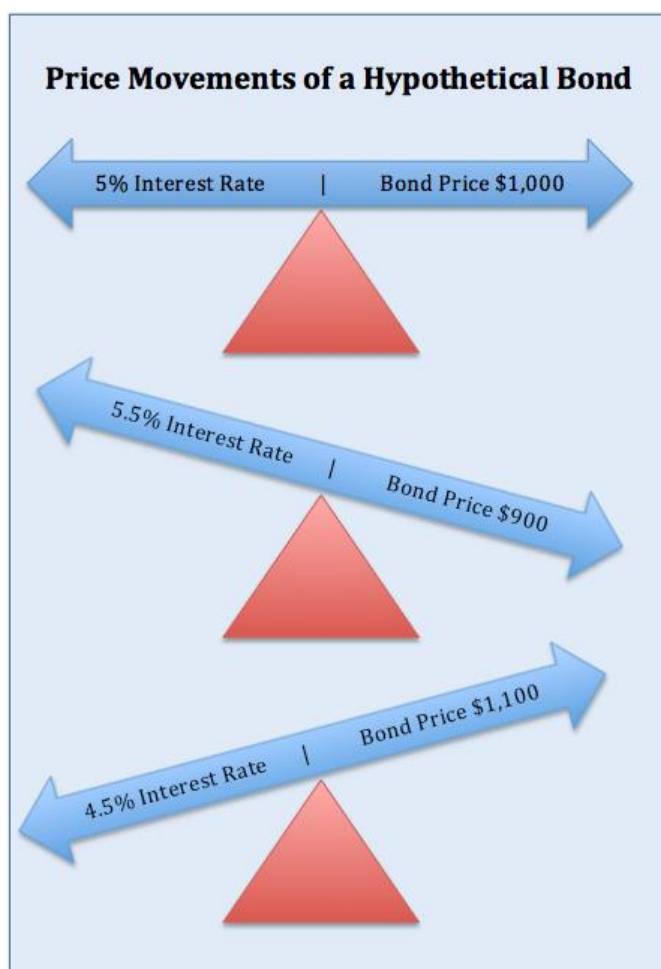
Interest rate risk and duration risk have become of particular importance in today's ultra-low interest rate environment. Currently, interest rates are at historic lows, meaning that there is a strong likelihood that interest rates may rise in the future.

INTEREST RATES AND THE FEDERAL RESERVE

The U.S. Federal Reserve has the dual mandate to promote economic growth and low unemployment while maintaining price stability (as measured by the inflation rate.) One of the most powerful tools in the Fed's arsenal is its ability to set the "federal funds rate," which is the rate depository institutions lend money to each other. This rate effectively sets all other interest rates used in banking activity, including the issuance of bonds.

In order to boost economic activity after the financial crisis, the Fed lowered the federal funds rate to nearly zero. When this failed to stimulate sustained economic growth, the Fed took a historic step and embarked on a series of "quantitative easing" programs, purchasing both Treasury Securities and Mortgage-Backed Securities in order to push long-term interest rates lower and support financial markets. QE3, the latest round of quantitative easing, targeted \$85 billion in monthly government bond and mortgage-backed security purchases. These purchases are designed to increase demand for these bonds, pushing bond prices up and interest rates down, boosting economic activity.

At some point in the future, the Fed will have to exit these quantitative easing programs and begin selling off their accumulated bonds. The pace and timing of these sales, as well as the tapering of the Fed's accommodative monetary policy will affect bond markets and bond investors. *As the quantitative easing programs come to an end, demand for bonds is expected to drop, potentially resulting in a decrease in bond values and an increase in bond yields. As the economy shows sustained improvement, the Fed is also expected to raise interest rates, pushing bond prices still lower.*



THE RELATIONSHIP BETWEEN BOND VALUES AND INTEREST RATES

Generally speaking, bond prices and interest rates have an inverse relationship, meaning that when interest rates rise, bond prices fall because new bonds are issued paying higher “coupon” or interest rates, making the older, lower-coupon bonds less attractive to investors. When interest rates decline, bond prices rise because the higher interest payments of the older bonds are more attractive than the new lower-paying bonds.

Generally speaking, the longer the term of the bond, the greater the price fluctuation or volatility that occurs from a change in interest rates. Duration risk is the risk associated with the sensitivity of a bond’s price to a one percent change in interest rates. The higher a bond’s duration, the greater its sensitivity to changes in interest rates and the greater the fluctuations in market price the bond may experience. If you sell a bond before maturity, the price you will receive (regardless of the face value of the bond) will be affected by the prevailing interest rates and the

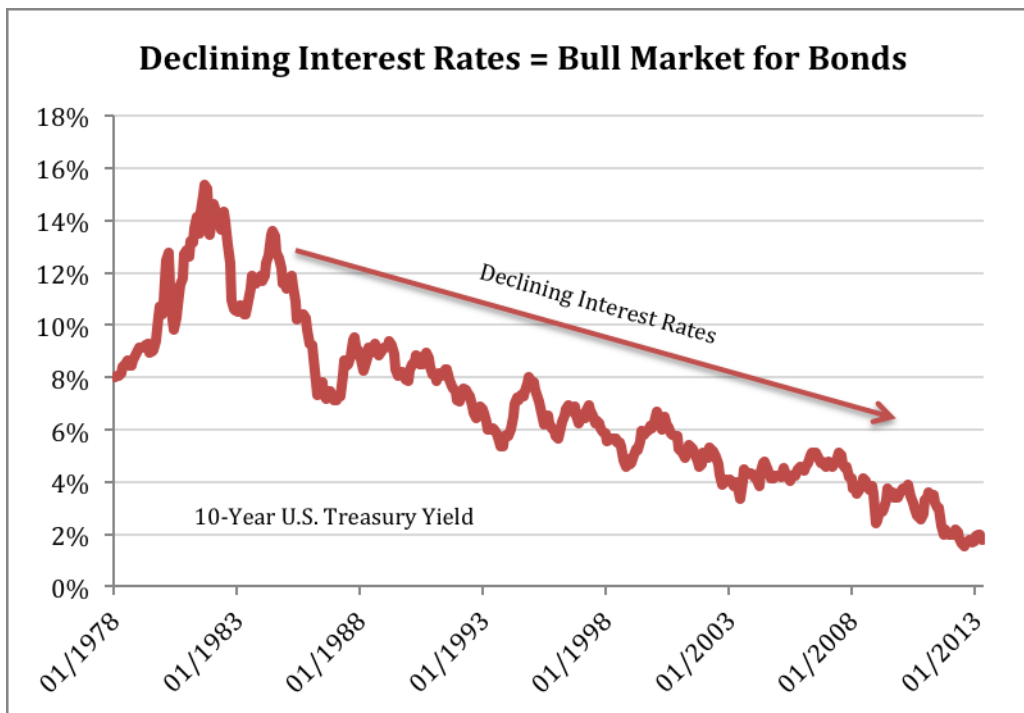
bond’s duration, as well as other fundamental factors of the bond.

Since interest rates are currently hovering near historic lows, many economists believe that interest rates are not likely to get much lower but will eventually rise. If and when this happens, outstanding bonds, particularly those paying a low coupon rate and with high duration, may experience significant drops in market value.

For example, if interest rates were to rise by two percent from today’s ultra-low levels, a medium investment grade corporate bond (BBB, Baa rated or similar) with a duration of 8.4 (10-year maturity, 3.5 percent coupon) could lose 15 percent of its market value. A similar investment grade bond with a duration of 14.5 (30-year maturity, 4.5 percent coupon) might experience a loss in value of 26 percent.⁵ The higher level of loss for the longer-term bond happens because its duration number is higher, making it more sensitive to interest rate changes.

It’s important to remember that these price fluctuations only matter if you intend to sell a bond before maturity. Bonds will pay out the same face value at maturity regardless of their market value, unless the issuer goes bankrupt or otherwise fails to pay back the principal.

⁵ “Duration—What an Interest Rate Hike Could Do to Your Bond Portfolio.” Investor Alert. FINRA. <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318> [Accessed 10-June-2013]



Source: Federal Reserve Bank of St Louis as of 2013-05-09

After peaking at above 15 percent in 1981, the yield on 10-Year Treasury Bonds has been in decline, reaching a historic low of near 1.38 percent in July 2012.

Although it is impossible to know for certain, many economists believe that interest rates will begin to rise in the near term, putting downward pressure on bond prices.

STRATEGIES TO HELP MITIGATE RISK

It's not possible to completely eliminate investment risks, however, there are strategies we can employ to help reduce the impact of certain risks. While future increases in interest rates pose definite risks to bond investors, the correct solution may not be to abandon the bond market; rather, investors should seek out solutions that help them prepare their portfolios for rising interest rates. Indeed, rising rates can be positive for investors since they may increase the availability of high quality, high-yield bonds.

One of the strongest tools in our arsenal is a personalized investment strategy that is never on autopilot. At any given time, there are many variables that can affect the value of your portfolio and we are constantly working to balance return against risk. Some of the strategies we employ include:

“Laddering” bonds, a strategy in which investors buy bonds with different, evenly spaced maturities can help reduce the effect of rising interest rates on your overall bond portfolio.

Reducing maturities through selling longer duration bonds and buying shorter duration debt securities can have the effect of reducing duration and reducing your portfolio's sensitivity to interest rate changes.

Holding international bonds from countries where interest rates are higher than in the U.S. can increase bond yields and help reduce durations. However, if considering this strategy, you must be mindful that international investing presents its own unique risks, such as currency fluctuations, political risks, and differences in accounting procedures.

Buying inflation-adjusted securities such as Treasury Investment Protected Securities (TIPS), whose payouts are adjusted according to the rate of inflation can help to reduce duration. This assumes that the rate of inflation rises in concurrence with an increase in interest rates, thus triggering an increase in the payout rate of the bond.

Investors can also look beyond the bond market for opportunities to earn higher rates of return.

Holding dividend-paying stocks can offer an income stream that may increase over time as companies increase dividend payments. Stocks offer growth potential over time that can help fight the effects of inflation. These advantages should be balanced against the potentially higher volatility of equity investments.

Pursuing alternative investment strategies that may have the ability to hedge against rising interest rates or earn a higher return in a rising rate environment. If you have questions about these strategies, please contact us.

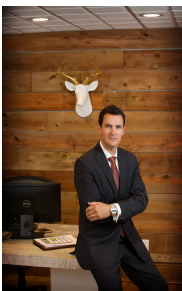
CONCLUSIONS & NEXT STEPS

We hope that you've found this special report informative, educational, and reassuring. We feel that it is important to educate our clients about the potential risks and benefits of bond investing. However, having said that, we certainly don't plan to abandon fixed income investments should interest rates increase. Rather, we plan to continue to monitor markets and seek out the opportunities that rising interest rates may send our way.

As financial guides for our clients, we work hard to achieve results while charting a course through shifting economic conditions. We also want to offer ourselves as a resource to you, your family, and your friends. We are happy to answer questions about your current financial situation and future goals, and we offer complimentary consultations at any time. Should you have any questions about bond investing or market movements, please reach out. We would be delighted to be of service.

Sincerely,

Scott Ramsay



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Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values.

Fixed income investments are subject to various risks including changes in interest rates, credit quality, inflation risk, market valuations, prepayments, corporate events, tax ramifications and other factors.

Opinions expressed are not intended as investment advice or to predict future performance.

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Consult your financial professional before making any investment decision.

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Investments in stocks involve risks including loss of entire principal.

While many securities aim to provide stable dividends, dividend payments are dependent on various factors such as market conditions and are not guaranteed. It also may be discontinued or modified at any time.

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