



Understanding Bonds

WHAT TODAY'S BRAVE NEW WORLD
IN BONDS MEANS FOR YOU

BY JOE BONNETT, CFP[®], ChFC[®]

BONNETT WEALTH MANAGEMENT

WHAT TODAY'S BRAVE NEW WORLD IN BONDS MEANS FOR YOU

The idea is simple: A bond is a loan. But just how and to whom you should make those “loans” calls for insight in today’s changing bond marketplace.

By Joe Bonnett, CFP®, ChFC®, Bonnett Wealth Management

Bonds have been booming for a decade. Investment performance has been excellent, and most bond investors have done well. But the days of relatively easy money are behind us. The bond market is changing.

I believe that we’re seeing the rise of a “Brave New World” in bonds. It reflects rising interest rates and declining bond prices. This is just the beginning of potential trouble facing bond investors.¹

At the same time, bonds can represent an important part of an investment portfolio. Opportunities exist to earn some decent returns. Many corporations, agencies and municipalities remain creditworthy bond issuers. As an investment, bonds are also valid because they generate steady income.

In this paper, I’m going to provide general background on bonds. I’ll explain what a bond is, who issues them and why they change in value. I’ll discuss why investors should own them and

outline general strategies. After reading this paper, you'll be able to understand bond basics. Future papers will cover more sophisticated forms of bond investing.

WHAT IS A BOND?

A bond is an I.O.U. You are giving an entity a loan², whether a corporation, such as Berkshire Hathaway, a municipality, such as the City of Omaha, or the U.S. government by buying Treasury securities. The bond issuer promises to pay you interest, usually at a fixed rate, and return the principal when the bond matures. Common maturities include 5, 10 and 30 years.

In general, there are four types of bonds:

1. Treasury securities. They're issued by the U.S. government, and include Treasury bills, notes, bonds and inflation-protected securities (TIPS) as well as savings bonds. Your broker or financial advisor can help you purchase them, or you can buy them directly at [treasurydirect.gov](https://www.treasurydirect.gov).³

2. Corporate bonds. They're issued by corporations, such as Procter & Gamble, General Electric and ConAgra. Some corporate bonds, known as asset-backed bonds, are issued to finance auto, credit-card, mortgage and other loans.⁴

3. Municipal bonds. Dubbed "munis," they're issued by cities, states, and other governmental entities to finance capital projects, such as building schools, highways or sewers, and to fund day-to-day obligations. They include general obligation bonds (backed by the "full faith and credit" of the issuer) and revenue bonds (backed by revenues from a specific project).

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They're typically tax-exempt. Some municipal borrowers issue bonds on behalf of private entities – colleges, hospitals – who agree to repay the issuer who pays the interest and principal.⁵

4. Agency bonds. They're issued by enterprises chartered and regulated in part by the government. While considered less safe than Treasury securities, they're often viewed as safer than corporate bonds.⁶

HOW DO BOND HOLDERS MAKE MONEY?

A bond is a promise made in exchange for interest and a return of principal. Here's how it works:

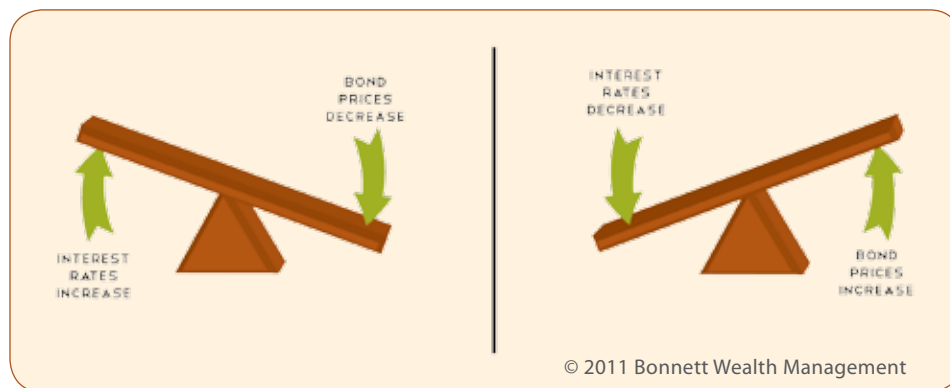
Suppose an individual pays \$1,000 to buy a 30-year bond at 6 percent interest.⁷ Every year, he earns \$60. If subsequent market conditions cause the bond's value to drop, he doesn't have to sell it. He still earns \$60 a year in interest. If the bond value rises, he has the option to lock in a premium price through its sale. If at the end of 30 years he still holds his bond, he collects his \$1,000 principal. He has earned \$1,800 in interest over the years.

Of course, I'm omitting the transaction fees and the costs associated with buying, selling and holding bonds, which as you probably know can vary by broker and investment account holder. Also, this explanation is simplified for illustrative purposes. In real life, buying and selling securities, including bonds, should always been done in conjunction with a plan that fits your wealth management needs and goals and should include help from a qualified advisor.

WHAT CAUSES BONDS TO CHANGE IN VALUE?

A couple of things have benefited bonds in the past few years. Demand has been significant. Anytime there's high demand for bonds interest rates typically are in decline. This is because bond values and interest rates go in opposite directions. Bond values rise in a declining and low-interest-rate environment. In contrast, when interest rates are high or are rising, bond values tend to drop.

The correlation between bond values and interest rates is like the opposite ends of a teeter-totter. Interest rates are on the one end, bond prices on the other. When one is up, the other is down. As interest rates go *down*, bond prices go *up*. And vice versa.



At the time of this writing, interest rates are going up. I don't pretend to have all the answers about the bond market and the future investment potential of the bond category. But, I expect to see bond prices heading down on the teeter-totter.

The U.S. economy has been in a low-interest-rate environment for some time. The U.S. Federal Reserve Bank has been artificially, but purposefully, keeping interest rates low, using mechanisms it has at its disposal. The goal of low interest rates is to stimulate

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the economy by making money “cheap” to borrow and, in theory, spurring investment and development.

However, a low-interest-rate environment has its drawbacks. Bank deposit and CD rates tend to be disappointing. This leads investors to pursue stock investments to boost the performance of their portfolios. As they move into stocks, interest rates seem inevitably to jump, and bond values decline.

Another problem is that a prolonged low-interest-rate environment can encourage inflation. The Fed typically responds by raising interest rates, which serves as the price tag for money, making it hard to borrow capital and constricting the money supply. As interest rates rise, bond values drop.

WHY OWN BONDS?

Bonds are considered relatively safe investments. They generate steady income.⁸ And, they can provide “ballast” to a portfolio by helping to offset stock market volatility.

Bond investing can be a good way to invest for current income. Even if interest rates rise, an investor could purchase higher-rated bonds that can net extra income.⁹

WHAT ARE THE BASICS OF SOUND BOND INVESTING?

Before doing anything, meet with a qualified advisor who understands your risk tolerance, long-term goals, short-term cash needs and more.

Don't make any sudden moves. Small incremental changes in allocation may be prudent. The bond market deals with *perceptions*. Do the majority of investors *think* that interest rates are going up, sending bond values down? We'll have to see. In my opinion, you'll want a reallocated position soon so that if bond prices go down you're not *reacting*.¹⁰

What reallocated position should you seek? Maybe stocks should comprise a greater portion of your portfolio. Maybe you should adopt a different bond investing strategy among individual agency bond, corporate bond and municipal bond issues.

There are three core principals for investing in bonds:

1. Diversify. Diversification is a way to manage risk by using a variety of investments. Ideally, all asset classes should have a measure of diversification, including stocks and bonds. Bond diversification involves spreading bond holdings among different issuers and maturity dates, and also includes making bond purchases on different dates of the year.

2. Buy quality. One means of controlling quality is by buying individual bond issues, so long as you diversify to minimize issuer-specific problems.¹¹

3. Ladder your bonds. This is a method for holding bonds of varying maturities within a portfolio, reducing reinvestment risk. As bonds mature, the investor moves money into newer bonds with higher yields.¹²

In my opinion, we have entered a Brave New World of bond

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investing. I am cautious about the outlook for bonds. But they still play an important role in a balanced portfolio. I suggest setting up an appointment with your advisor to discuss your bond investing strategies.¹³

It's good to review your bond portfolio regularly. That way you'll have the ability to make changes as market conditions warrant.

ABOUT THE AUTHOR

Jerome "Joe" P. Bonnett, Jr., CFP®, ChFC®, is an Independent Wealth Manager and President of Bonnett Wealth Management, Omaha. He is a 1987 graduate of the University of Nebraska with a bachelor's degree in business administration, finance and banking. He is a Registered Representative of Securities America, Inc. Member FINRA/SIPC. Joe resides in Omaha with his wife Susan (Engdahl) and their two children, Jake and Claire. Bonnett Wealth Management and Securities America companies are unaffiliated.

GLOSSARY

Coupon. This is the interest rate paid by a bond. For instance, a \$1,000 bond with a 6% coupon will pay \$60 a year. The word coupon is used, because some bonds really had a paper coupon attached to them that could be redeemed for payment.

Maturity date. The date to which you agree to lend your money to the bond issuer. Bonds with longer durations – say a 10-year bond versus a one-year bond – pay higher yields.

Par. This is the face value of a bond, the amount a bondholder receives when the bond matures. If interest rates rise higher than the bond's rate, the bond will trade at a discount, or below par. If rates fall below the bond's rate, it will trade at a premium, or above par.

Interest payment. The bond issuer pays interest to the trustee named in the bond agreement. The trustee transfers the money to the paying agent, who makes interest payments to the bondholders. The trustee and paying agent are often the same banking institution.

Treasury securities. They're issued by the U.S. government and are considered the safest bonds on the market. They're used as a benchmark to price other bonds.

Source: SEC, WSJ.com material adapted from "The Complete Money and Investing Guidebook" by Dave Kansas.

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Bond investing involves risk, which can result in the loss of principal. Bonds are subject to interest rate risk, which means the price of bonds may decrease as interest rates increase. Bonds are also subject to credit, or default, risk. Credit risk varies with bond issuers. Municipal bonds depend on the financial health of the particular issuer (such as state and local governments) and its ability to raise revenue. Credit risks associated with corporate bonds are linked to the companies' balance sheets, income statements, and earnings capacities. Any fixed income security sold prior to maturity may be subject to a substantial and taxable gain or loss.

Diversification seeks to reduce the volatility of a portfolio by investing in a variety of asset classes. Neither asset allocation nor diversification guarantee against market loss or greater or more consistent returns.

Corporate Bonds – There is risks associated with fixed income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities. Non-investment-grade securities, commonly called "high-yield" or "junk" bonds, generally have more volatile prices and carry more risk to principal and income than investment grade securities.

U.S. Government Bonds – Although backed by the full faith of the government, there are risks involved to include: relative yield risk, reinvestment risk, inflation risk, market risk, selection risk, timing risk, legislative risk, duration risk and call risk

Bond Ladders may not ensure adequate diversification of your investment portfolio. You must evaluate whether a bond ladder and the securities held within it are consistent with your investment objectives, risk tolerance, and financial circumstances. If you decide to include callable bonds in your ladder, these bonds may be called prior to maturity. If a bond is called, your interest payments cease and the principal is returned as of the call date. If you seek to reinvest the principal in a similar bond issue, you will likely have to accept a lower yield (and lower interest payments) consistent with prevailing interest rates. The ladder attempts to mitigate reinvestment risk, as bonds are scheduled to expire at regular intervals. You can reinvest the proceeds further out in the ladder, and buy bonds during varying market and interest rate conditions. A called bond will alter your payment schedule and the scheduled intervals of principal coming due.

Municipal bonds are federally tax-exempt, and may be exempt from state and local taxes. Municipal bonds purchased at a discount may be subject to capital gains tax. Investors are encouraged to weigh all of these factors before they invest in municipal bonds. Investors should take into account the overall economic health of the region or customer base and the impact it might have on the revenues the entity depends upon in order for it to sustain its bond payment commitments. Understand the exact source of the revenues that will service and repay the debt. Consider the entity's track record of operational effectiveness. Assess the competence of financial management of the entity. Has its credit rating been maintained or strengthened over a period of time. Read the issue's Official Statement, this document will provide the information covered above. Finally, investments in Municipal Bonds may subject the investor to the Alternative Income Tax (AMT).

This material is for general informational purposes only and should not be considered a recommendation to buy or sell any security, nor a specific investment strategy. Securities America and its representatives do not provide tax or legal advice. Readers should consult their tax advisor, or legal counsel, for advice concerning their particular situation.

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