



## February 2010 Hot Topics

# Bonds: What You Need to Know

*Money is flowing into bond mutual funds at a dizzying pace this year. If the trend continues, bond funds will attract more than twice as much new money as they did in 2008 and a stunning 11 times more than investors are putting into stock funds this year.*

Bond funds don't ordinarily have greater inflows than stock funds, but may occur during periods of stock price volatility. This development is not surprising, but it is interesting nonetheless. Here's why.

Interest rates are low and the Federal Reserve is likely to keep them low for the foreseeable future. As long as joblessness remains a problem, the Federal Reserve will be reluctant to raise interest rate targets and, in fact, has little reason to do so. Interest rates are one way to control the growth of an economy. When the economy is growing too fast and is at risk of high inflation, the Fed can slow it down with higher interest rates. An economy with high unemployment is unlikely to suffer from too-rapid growth and job creation would probably suffer from higher interest rates. Thus higher interest rates are not likely until the jobless rate begins to decline.

### Bonds 101

But interest rates will inevitably go up. When interest rates rise, the value of existing bonds typically falls and may adversely affect a bond fund's performance. The face value of a bond and the current interest rate is an inverse relationship. And the reason is simple.

A bond is a debt instrument, usually tradeable, that represents a debt owed by the issuer to the owner of the bond. Most commonly, bonds are promises to pay a fixed rate of interest for a number of years, and then to repay the principal on the maturity date. In the U.S. bonds typically pay interest every six months (semi-annually), though other payment frequencies are possible. When interest rates are low the issuer is taking out a loan at a low fixed interest rate. This is no different than a person securing a long term mortgage at the low interest rate.

### Bond Valuation

The value of any asset is the present value of its cash flows. So what happens to a bond paying 4% when the interest rate climbs to 8%? It will be valued at a discount to the face value to compensate the buyer for the lower than current interest rate. The longer the term to maturity the less it will be worth.

For example, let's assume a new bond today that has:

- 1) 20 years to maturity
- 2) face value of \$1,000
- 3) interest rate of 4% paid semiannually

This bond will pay to the holder 4% of its face value in interest each year. Since it pays semiannually, there will be 40 payments of \$20 each and the \$1,000 will be returned at maturity (at the end of period 40). If current interest rates on a CD was 1.5%, then buying this bond for \$1,000 may look like a good deal.

Let's say over the next five years the economy improves, inflation kicks in and the interest rate paid on a CD is 8% and you are thinking about selling this bond. Unfortunately, this bond is only worth \$777.63 because it represents an investment at a lower than current rate. A buyer will pay less than face value to compensate for the lower rate. Note, however, that the bond will still pay \$40/year in interest and return the face value of \$1,000 at maturity. (On the other hand, if the economy in the above example remains depressed and the current yield remains at 1.5%, the value of the bond would rise to \$1,176.)

Investors who were smarting from their losses may have soured on stocks and decided the conservative return potential in the debt markets might be more appealing than the chance of suffering further losses in the equity markets. Realize, however that currently issuing bonds will be trading at a steep discount to their face value if interest rates rise.

It's important to remember that you will receive the interest payment semiannually and the full face value at maturity regardless of current interest rates. The risk is

---

#### Important Disclosure Information

USA Living Financial Group is a fee-based Registered Investment Advisor firm. The material presented here is for informational purposes only. Consult your personal legal, tax and insurance professional before making any financial, estate planning or insurance related decisions.

the opportunity lost risk because you could invest your money somewhere else and earned a higher rate of return.

## Bonds vs. Bond Funds

There is a big distinction between bonds and bond funds. An investor who buys individual bonds is typically interested in generating income and preserving principal. Investors who are careful to stagger the maturity dates in their bond portfolios may be able to further reduce the risk of having to reinvest a large percentage of their principal when rates are low. This was discussed in the October 2009 article titled "*Managing Volatility with a Ladder*".

Bond funds generally employ a less conservative strategy by trading bonds before they mature in order to pursue gains by taking advantage of fluctuating interest rates. Bond funds will typically turnover their holding from 50% to over 200% each year. This may allow them to offer greater return potential, but sometimes with higher risk. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with the underlying bonds in the funds.

Bonds, bond funds and bond ETFs can play an important role in an investment portfolio, but they shouldn't be thought of as a safe harbor to park money until the stock market settles down. Bond funds/ETFs are used in a portfolio to balance and compliment the equity investments. In addition, they should be a part of every investor's portfolio because bond funds and ETFs produce monthly income.

Take for example, the Vanguard Long-Term Bond Index Fund (VBLTX). This fund holds a range of securities that approximates the performance of the long term (15 to 30 year) bond market. It opened in June 1996 and sold for about \$9.58/share. It finished December 2009 selling for \$11.56/share. In the mean time, it paid around 0.053 cents per share every month in interest payments. A purchase \$10,000 of shares in June 1996 would be worth about \$12,066 today and would have paid around \$55/month, or about \$660/year for a total of around \$8,900 in interest payments. A nice addition to anyone's portfolio. Note: The NAV of a bond fund/ETF is the only consideration when evaluating the fund's performance. Dividends paid are not a consideration.

The decision to purchase a bond fund should be made based on your personal circumstances, such as your time horizon, risk tolerance, and personal goals. Bonds and bond funds come in a variety of forms which were discussed in the August 2009 newsletter in an article titled "*Navigating the Bond Market*".

Exchange-traded funds and mutual funds are sold only by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

The information in this article is not intended as tax or legal advice, and it may not be relied on for the purpose of avoiding any federal tax penalties. You are encouraged to seek tax or legal advice from an independent professional advisor. The content is derived from sources believed to be accurate. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. This material was researched and written by David Snellen. © 2010 USA Living.com, Inc.

## What's Ahead for 2010?

*The U.S. economy is expected to grow a respectable 3% in 2010, according to a consensus of economists who are polled on a regular basis by The Wall Street Journal.*

What else do experts think will happen in 2010? Here's a roundup of what's scheduled, expected, and predicted.

## The Recession

Something most people will be looking for in 2010 is the end to the economic recession that began in December 2007. The average duration of each U.S. recession that has ended since 1945 was about 10 months, although the longest was 16 months. That would make the end of the current recession long overdue by historical standards.

But don't hold your breath waiting to hear the recession is over: In the past, the National Bureau of Economic Research, the nation's official recession timekeeper, has taken an average of 15 months after a recession is over before it makes a pronouncement to that effect.

## Inflation and Interest Rates

Inflation is not expected to be much of a threat to economic activity and should remain in the range of 2% at least through 2010. And because inflation plays a dominant role in the Federal Reserve's decisions on interest rates, it seems likely that rates will remain near their current levels.

---

### Important Disclosure Information

USA Living Financial Group is a fee-based Registered Investment Advisor firm. The material presented here is for informational purposes only. Consult your personal legal, tax and insurance professional before making any financial, estate planning or insurance related decisions.

## Unemployment

Few economic indicators are more important or more visible to Americans than the unemployment rate. As long as it remains above the 5% to 6% range, any economic recovery might not feel like much of a recovery at all. And yet, the jobs picture is expected to remain bleak. In *The Wall Street Journal's* December 2009 economic forecasting survey of 51 economists, the average forecast was for a 9.6% national unemployment rate by December 2010. Just four of the 51 economists surveyed expected the unemployment rate to dip below 9% by then.

## Taxes: Income, Capital Gains, Dividends, Inheritances

A bundle of favorable federal tax laws that were passed in 2001 and 2003 are scheduled to expire after December 31, 2010. If Congress takes no action to extend these tax laws, we can expect higher tax rates on income (up to 39.6% from the current top rate of 35%), long-term capital gains (up to 20% from the current 15% rate), dividends (up to 39.6% from the current 15% rate), and inheritances (0% in 2010 but then up to 55% in 2011 on estates larger than \$1 million).

Given that 2010 is an election year, taxes are going to be a touchy topic. Because tax rates are slated to rise automatically in 2011, the debate could take an unusual direction. Proponents of higher taxes will need only to scuttle any new legislation to extend the lower rates, while low-tax proponents will have to muster the political will to pass tax cuts despite the fact that the federal government is facing a huge national debt and growing obligations to entitlement programs such as Social Security, Medicare, and federal employee pensions.

## Financial Markets

There is never a way to predict how the financial markets will perform — something that was on full display in 2009. The year began in the midst of a nasty bear market that took the Dow Jones Industrial Average to near 6,500 by March. You might recall those tense early months of 2009, when the market seemed determined to test a new low every day, with no bottom in sight. It's unlikely that you expected the market to recover to 10,000 by October and soon after would be posting year-over-year double-digit gains — yet that's exactly what happened.

Attempting to predict how the stock market — or any investment — will ultimately perform is a great way to waste time, but hardly the best method for reaching your

long-term goals. Investments seeking to achieve higher returns also involve a higher degree of risk. Shares, when sold, may be worth more or less than their original cost.

It's a good idea to keep an eye on what is on the horizon, but it's no substitute for following a long-term strategy based on your personal situation, risk tolerance, time horizon, and investment objectives.

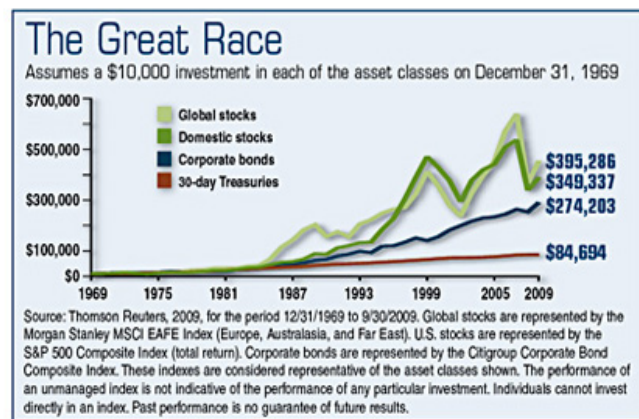
*The content is derived from sources believed to be accurate. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. This material was written by Emerald. © 2010 Emerald.*

## Don't Forget the World

*If you had to rank domestic large-cap stocks, corporate bonds, 30-day Treasury bills, and global stocks according to their risk levels, which one would you say carries the greatest risks? Given the perilous state of the world economy during the past several months, most people would probably say global stocks.*

If you had to rank these same asset classes according to performance, which would you say was the top performer? Over the past 40 years, it was global stocks, despite losing an incredible 43% of their value in 2008 (see graph). Over the long term, global stocks and the S&P 500 have experienced comparable gains, but in any given year they may turn in disparate performances.

If your portfolio doesn't include some global equities, it might be missing a key dimension. Global investing carries significant risks that are not to be taken lightly, so it is not appropriate for everyone. It's a good idea to consider whether you are comfortable with the risks before you pursue the potential rewards.



### Important Disclosure Information

USA Living Financial Group is a fee-based Registered Investment Advisor firm. The material presented here is for informational purposes only. Consult your personal legal, tax and insurance professional before making any financial, estate planning or insurance related decisions.

## Globalization vs. Political Instability

Developments in technology and trade agreements have opened new markets and opportunities for the world's economies, whether they are emerging or already industrialized. However, not all nations are able to enforce contract and property rights to the same degree that has made the United States such a great place to invest. A decision to invest in another country must begin with an understanding of the political and economic forces at work in the region.

## Diversification vs. Currency Fluctuations

The dollar has a record of stability that is hard to match, but its recent weakness is a reminder that dollar-denominated investments can be risky, too. Investing abroad offers the opportunity to help manage these risks by spreading them across multiple economies and currencies.

However, currency fluctuations also pose risks. If an investor's domestic currency is strong against a foreign currency, the investor may be able to gain purchasing power when exchanging to the weaker currency. But if the foreign currency continues to weaken, any investment gains and the principal may lose value when exchanged back into the domestic currency. Staying abreast of the forces that influence a particular currency's value is essential to successful global investing.

## Stellar Potential vs. Financial Reporting

The greatest return potential is frequently associated with the greatest risks. This is true whether you are talking about a start-up company or a fledgling economy. Because the U.S. economy is mature, its accounting standards are among the most rigorous in the world. Growing economies are often marked by lax accounting standards, which can make it more complicated to perform the due diligence that is essential to finding sound investment opportunities.

The risks of global investing are numerous, but so are the potential opportunities. A decision to pursue foreign investment opportunities should begin with a thorough examination of your risk tolerance.

The content is derived from sources believed to be accurate. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. This material was written by Emerald. © 2010 Emerald.

## What Does a Fed Chairman Do?

*The Chairman of the Board of Governors of the United States Federal Reserve might sound like a lofty title for some smart guy in an ivory tower.*

Yet the person who occupies this key position in the nation's central bank can have a tremendous influence over important aspects of daily life, such as the interest rate your bank savings account pays or how much your next pair of shoes may cost.

Here's a look at the aspects of ordinary life that can be affected by the actions of the Fed and its chairman.

**Interest rates** — The Fed is charged with helping maintain the best possible conditions for economic growth. The Federal Open Market Committee, led by the Fed chairman, adjusts two key interest rates in pursuit of this goal. These two rates, which affect the rates banks pay to borrow from each other and from the Fed itself, influence rates paid by consumers on credit cards, auto loans, and mortgages.

**Inflation** — High inflation is both a symptom of economic growth and, if left unchecked, its death knell. Coincidentally, the Fed uses interest-rate policy to defend against inflation, which can occur when the economy is growing too fast. By raising rates, the Fed reduces the availability of credit, thereby helping to slow economic growth to a more reasonable rate, which can help keep prices from rising faster than most people's incomes.

**Credit conditions** — Interest rates are only one aspect of credit conditions. The Fed also enacts or advocates policies to help protect both borrowers and lenders from extreme risks.

**The national mood** — The chairman routinely communicates with the public in speeches to Congress and in statements about interest rates. What he says and how he says it can influence the mood of the financial markets, which are looking for optimism and a confident outlook.

The Federal Reserve plays an important role in our economy, and the chairman is its most visible player. His behavior is a good source of clues about what the future may hold.

The content is derived from sources believed to be accurate. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. This material was written by Emerald. © 2010 Emerald.

---

### Important Disclosure Information

USA Living Financial Group is a fee-based Registered Investment Advisor firm. The material presented here is for informational purposes only. Consult your personal legal, tax and insurance professional before making any financial, estate planning or insurance related decisions.