



Navigating the Bond Market

Bonds are fixed income investments. In other words, a bond (purchased individually or via ETF or mutual fund) is a debt security. In effect, you are loaning money to the government, a municipality or a company in the expectation of receiving monthly, quarterly or semi-annually interest payments, in addition to return of the principal.

Bonds are subject to their own set of investment risks including reinvestment risk, interest rate risk and purchasing power (inflation) risk. These risks affect all forms of corporate, government and municipal bond issues. Government bonds however are not subject to default risk, that is, the risk that a creditor may seize the underlying collateral of a bond (if any) and sell it to recoup the principal. Also, government bonds do not have credit risk which is the risk that the issuer cannot make interest and principal payments.

The credit risk of a bond issuer can be determined by reviewing the credit rating assigned by the bond rating agencies, most notably the private firms of Standard & Poor's and Moody's. Both firms rate a corporate bond issue as either Investment Grade or Non-Investment Grade (Speculative) grade. The grade assigned is a judgment call so it is recommend you (or your investment advisor) do your own due diligence on the issuer.

An alternative to individual bonds are bond ETF or mutual funds. A bond ETF/Mutual funds is a portfolio of individual bonds that have similar credit ratings. For example, the Dodge & Cox Income fund (DODIX) has an Average Credit Quality of AA (high grade) and Yield of 5.72%¹. On the other hand the Vanguard High-Yield Corporate mutual fund (VWEHX) has an Average Credit Quality of BB (Speculative) with a Yield of 8.40%.

You will notice with these two examples that the less the quality of the bond, the higher the yield. This is because for a lesser creditworthy company to sell its bonds, it must offer an interest rate high enough to attract a buyer. Contrast the two examples with the iShares Barclay 1-3 Year Treasury ETF (SHY) with a yield of 3.16% but no credit risk.

Bonds should be a portion of every investor's portfolio regardless of age. The only variables being level of acceptable risk and percentage of portfolio. As the

investor ages, shifting toward a larger allocation of bonds along with a move toward less risk in the bond allocation is necessary.

Bond Options

Municipals Bonds – Issued by state and city governments who use the money to build schools, sewers or other high ticket items. Most municipal bonds are free from federal income taxes and state tax (if the investor lives in the state that issued the bond. Because of the tax advantage, munis have historically offered much lower yields than Treasury bonds. The **SPDR Barclays Capital Municipal Bond** (TFI – 3.88%), **Fidelity Municipal Income** (FHIGX – 4.31%) and **Vanguard Interm-Term Tx-Ex** (VWITX – 4.00%) are three funds in this classification..

Government agency bonds – Ginnie Mae, Fannie Mae and Freddie Mac issue bonds backed by the payments from mortgages. Since the federal takeover of Fannie and Freddie, their bonds are effectively guaranteed. Ginnie Maes are also government backed. The yields tend to be higher than Treasuries. The **Vanguard GNMA** (VFII - 4.61%), **Payden GNMA** (PYGNX – 4.88%), **Fidelity Ginnie Mae** (FGMNX – 4.65%) and other funds can provide exposure.

Treasury bonds and TIPS – The interest and principal are guaranteed by the government. The downside is the safety is paid for with lower yields. The yields on Treasury Inflation Protected Securities (TIPS) are designed to float with the inflation rate. **iShares Barclay TIPS Bond** (TIP – 4.68%²) and **SPDR Barclays Capital TIPS** (IPE – 3.38%) are two ETFs that invest in TIPS.

High-grade corporate bonds – Corporate bonds generally have higher yields when compared to

¹ All stated yields are as of July 15, 2009

² Due to the market volatility of the past year, the yields shown may not represent a true picture of the yields available with this class of bonds.

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.

Treasurys. They are not risk-free but the bondholders are ahead of stockholders if the company runs into financial trouble. **RidgeWorth Investment Grade Bond** (STGIX – 4.28%) and **iShares Barclays MBS Bond** (MBB – 3.85%) are two plays in these bonds.

High-yield bonds – Often called ‘junk bonds’, these riskier cousins of high-grade corporates are issued by companies that have to pay higher interest rates to attract investors. These funds can be tempting because of the high yields, but remember they are paying higher yields for a reason. Two funds in this agenda are **SPDR Barclays Capital High Yield Bond** (JNK – 13.25%) and **T. Rowe Price High-Yield** (PRHYX – 8.32%).

As with any investment, always read the prospectus and make sure you understand all the fees and expenses associated with a bond or bond fund purchases. High fees may cut into your returns.

© 2009 USA Living Financial Group

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.