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Financial Briefs

JULY 2016

Active vs. Passive Bond Investing

A great many investors are aware of only one way to manage their bonds: buy and hold them until they mature, reinvesting the redeemed funds in more bonds to hold until *they* mature. Not surprisingly, this is called a buy-and-hold strategy, and it's considered a form of passive management.

But there is another way to approach a bond portfolio. It's called active management and routinely involves selling bonds before they mature. Before considering active management, however, it's important to understand some bond fundamentals.

Bond Income vs. Capital Gains

Everybody knows that bonds generate income in the form of interest payments. But many people don't realize that bonds can also generate capital gains in the secondary market — the market where investors buy and sell existing bonds.

Interest rates are the result of prices that investors are willing to pay to receive the fixed-income streams from existing bonds. Whenever potential buyers of existing bonds decide that the bonds' annual income isn't enough relative to its price, they'll bid bond prices lower. As a result, the bonds' current yield, their effective interest rate, will rise. The result is that at any given time, the market value of a certain bond could be higher or lower than its face value, its original price, or its previous transaction price.

Individual bond prices can also change as a result of changes in their credit ratings. If a major bond agency reduces the rating of a bond, its price will normally go down; if the rating goes higher, the price will ordinarily go up. In either case, the price is bound to be different from its price when you bought it.

Selling to Capture Premiums or Higher Yield

Bonds whose prices are higher than their face value — something

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4 Reasons to Invest in Bonds

Bonds have a reputation as safe, stable investments. But writing off bonds as boring investments that are best for the risk-averse could be a mistake.

While it's true that investing in bonds tends to lack the dramatic highs (and lows) that come with investing in stocks, that doesn't mean you should ignore the opportunities bonds present. Here are four reasons you might want to have a portion of your portfolio in bonds.

1. Bonds are a way to diversify your portfolio.

Many financial experts recommend diversifying your portfolio to include a variety of asset classes, including bonds. This is a concept known as asset class diversification. Because various asset classes tend to perform differently at alternate times, you may be able to create a portfolio that generates more stable returns by investing across asset classes. For example, stocks and bonds tend to historically move in opposite directions, which means that owning some of both can help smooth out the ups and downs in your portfolio.

2. Bonds are (usually) less risky than equities.

If you are looking to decrease risk in your investment portfolio (such as when you near retirement), increasing your allocation to bonds may be one way to do that. However, keep in mind that less risky doesn't mean risk free. Bond issuers can default, plus you face what's known as inflation risk. Because bond payments are set in advance (that's why they're known as fixed-income investments), you may lose purchasing power due to inflation.

3. Bonds can provide a steady, predictable source of income.

Stocks and other investments are unpredictable — you don't know with any certainty how well a stock might perform in any given year or even how well certain types

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Riding Out the Economic Storm

By Carol Ringrose Alexander

In a volatile market like the one we are experiencing, being patient is much easier said than done. Currently, terms like "Brexit" fill the headlines. Over the past year, China devalued their currency and the Federal Reserve continues to contemplate when to raise interest rates resulting in daily market fluctuations that can make the market seem like quite a roller coaster.

It is important to keep the current situation in perspective.

- **Bear markets are normal** – The usual definition of a bear market is when stocks decline at least 20 percent from their peak. From 1900 through 2013, there were 123 corrections (about one per year) and 32 bear markets (one about every 3.5 years), according to Ned Davis Research.
- **Since 1945, the U.S. has faced 12 recessions.** The average duration of those recessions was 10 months: the shortest was six months (January to July 1980), while the longest (December 2007 to June 2009) lasted 18 months.
- **Every bear market in the past eventually gave way to new record highs** in the S&P 500, according to data from Vanguard. We have no reason to think this time will be different.

A decision to sell investments in a bear market and go to cash or to purchase more bonds assumes you can time the market correctly two times, both when you sell the investments and when you reinvest in the market.

In 2005, H. Nejat Seyhun, a professor of finance at the Ross School of Business at the University of Michigan, tested the long-term damage that investors could do to their portfolios if they missed out on the small percentage of days when the stock market experienced big gains. From 1963 to 2004, the index of American stocks he tested gained 10.84 percent annually in a geometric average, which avoided overstating the true performance. For people who missed the 90 biggest-gaining days in that period, however, the annual return fell to just 3.2 percent. Less than one percent of the trading days accounted for 96 percent of the market gains.

Another similar study in the *Journal of Investing* was published by Javier Estrada, a professor of finance at IESE Business School in Barcelona. This study looked at equity markets in 15 nations, including the United States. A portfolio belonging to an investor who missed the 10 best days over several decades across all of those markets would end up, on average, with about half the balance of an investor who kept his portfolio intact.

Although you may consider making a change to a more heavily bond-weighted portfolio when the market drops, that change can be detrimental to achieving your long-term goals. The advice we give our clients, who have well-diversified portfolios that were designed to withstand the ups and downs of the market, is to stay the course.

- **Stay calm** – As you may have noticed, the market does not deliver returns in a straight line. To capture the average return, which is 9.2 percent over the past 50 years, investors have to be in the market for the long haul. Since 1926, the market produced gains in 66 out of 90 years, more than twice as often as it produced losses.
- **Stay in the market** – Successful investing requires the ability to endure corrections when the market drops 10 percent or more. Selling investments when the market is down means an investor will forfeit the returns that typically follow a downturn. Historically, the market has posted an average 25 percent return in the 12 months following a correction.
- **Stay the course** – During the past 10 years, the S&P 500 Index has realized a cumulative return of 65.24 percent. However, to have benefited from such performance, an investor would have had to stay the course through periods of significant volatility. An investor who missed just 10 of the best-performing days in the past decade would have lost out on half of the gains.

So when you listen to the news, remember to focus on your long-term goals and stay the course that you charted with your advisor. By maintaining your disciplined investment approach during good times and bad, you will be positioned to realize the benefits as the market improves.

Active vs. Passive

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that often happens when interest rates have been falling for some time — are called premium bonds. If you're holding a premium bond to maturity, one thing is certain: no matter what happens to interest rates in the future, you're never going to benefit from this temporary increase in your bond's market value — unless you sell it. So in the right circumstances, it can make sense to sell a premium bond.

In certain circumstances, it can make sense to sell a bond that's fallen to a lower price than its purchase price. Why? First, selling a bond at a loss generates a potential tax advantage — a capital loss that come tax time, can be used to offset capital gains taken elsewhere. Second, in a market in which bond prices are falling, bond interest rates are rising. So investors can increase their net income if they sell a lower-yielding bond to purchase a higher-yielding bond.

Using the Yield Curve

Professionals know that the bond markets are more inefficient than the stock markets. One of the results is that anomalies frequently occur in what's known as the yield curve, the line on a graph that shows yield by maturity dates.

In theory, there is a gradual and proportional relationship between time to maturity and yield. On a normal yield curve, the line rises a bit steeply from left to right over the first few years and then begins to flatten out, with yields continuing to rise as the maturity gets longer.

In practice, however, abnormal relationships can emerge in which the yield for a slightly shorter maturity is higher than the yield for a certain longer maturity (an inverted yield curve). In this case, a premium may have developed for the longer maturity that could disappear once the market becomes fully aware of it. In such cases, active managers may decide to sell the longer maturity and buy the shorter one to book that capital gain.

Please call if you'd like to review your bond portfolio.

Dealing with Bond Price Fluctuations

There are two primary factors that affect bond prices — interest rate changes and credit rating changes. Interest rate changes typically will cause a bond's value to fluctuate more than credit rating changes.

As interest rates rise, a bond's price adjusts down, while the bond's price will increase when rates decrease. Simply put, bond prices and interest rates move in opposite directions. Also, bonds with longer maturity dates are more vulnerable to interest rate changes, since the difference will impact the bond for a longer time period. One of the reasons longer-term bonds typically pay higher interest rates is because there is more risk that interest rates will change during the bond's life.

Credit ratings also influence a bond's price. When a bond is issued, rating agencies assign a rating to give investors an indication of the bond's investment quality and relative risk of default. Typically, higher-rated bonds pay a lower interest rate than lower-rated bonds. After the bond is issued, the rating agencies continue to monitor it, making changes if warranted. A bond's price tends to decline when a rating is downgraded and increase when a rating is upgraded. The price change brings the bond's yield in line with other bonds with similar ratings. However, these price changes are typically minor if the rating changes by only one notch. Certain downgrades are more significant, such as a downgrade that moves a bond from an investment-grade to a speculative rating, a downgrade of more than one notch, and a series of downgrades over a short period of time.

4 Reasons

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of stocks (like small-cap stocks or international stocks) will do. Bonds are a bit different. They are debt investments, which means you are essentially agreeing to loan an entity, like the government or a corporation, money for a certain period of time. That entity agrees to pay you a certain amount of interest (known as the coupon) over the time they have your money, plus repay your initial investment when the bond reaches maturity. That means unlike some other investments, you have a pretty good idea of how much money you're going to receive from your bond investments over the years.

Of course, bonds aren't risk free. Bond issuers can default, and you could experience a loss. That's why riskier bond issuers tend to offer investors higher coupon rates — their greater risk is compensated by greater total return. But in general, bonds are more predictable in how much money they generate for investors than stocks, which is one reason they're so appealing to retirees.

4. Bonds can provide valuable tax savings.

Depending on the types of bonds you own, you may be able to save on taxes. While you'll pay normal taxes on corporate bonds, income from Treasury bonds (which are issued by the U.S. federal government) is free of state and local taxes. Then there are municipal bonds, or bonds issued by state and local governments. You won't pay federal tax on money earned on these investments and may also be exempt from state and local taxes. For anyone who is looking to minimize their tax burden, especially retirees, this can be an appealing proposition.

Questions about making bonds part of your investment strategy? Please call to discuss this topic in more detail.

News and Announcements

From the Alexander Household

"Family faces are magic mirrors looking at people who belong to us; we see the past, present, and future."

~ Gail Lumet Buckley

(writer, daughter of Lena Horne)

For us, this is the summer of family reunions. We look forward to time with extended family who we don't see often enough. We're grateful to those who are organizing the reunions to give us the opportunity to spend time together.

In June, we spent the weekend with my mother's family in San Antonio. Rather than sightseeing, we enjoyed spending time together. In July, we will spend the weekend with Kerry's father's family in Austin, which is a larger group because his grandfather was one of nine children.

At times like this, I remember those family members who are no longer with us and look forward to the future. It is a reminder of how complex family relationships can be and the strength of these ties.

Carol Ringrose Alexander,
CFP®, AIF®, CDFA™

From the Flinton Household

"To be yourself in a world that is constantly trying to make you something else is the greatest accomplishment."

~ Ralph Waldo Emerson

With all the fun we have enjoyed the past couple months, this feels like one of the shortest summers of recent memory. Although I'm excited for my daughters, Samantha and Emerson, as they both love school so much, I'm also saddened that the days of sleeping in a bit later and having unhurried mornings will soon come to a close.

Both girls are still in dance and have a renewed sense of wonder, as they are no longer in the same class and have their own individual identities within their respective groups. As the girls get older and their unique personalities emerge, it's funny to hear what comes out of my mouth at times, because they have started to pick up and repeat common phrases around the house. However, they both have developed their own keen sense of humor.

Just a few weeks ago, Courtney and the girls were waiting for me to finish a dentist appointment, and obviously the kids were "starving!" Well, the closest option was someplace we try to steer clear of, however, this day convenience won out. As they hit the drive-through, Courtney told the girls they could get an item, but they weren't getting a Happy Meal. She explained that they didn't need french fries or a drink or a toy. They could get water. Without missing a beat, an exasperated four-year-old exclaimed, "It sounds like we're getting a Sad Meal!" Out of the mouths of babes.

Make it a great month,

Andrew Flinton, CFP®

From the Rudy Household

About six years ago, Kayla, our 14-year-old, was very interested in our family hosting a foreign exchange student. I don't actually know where she learned of the idea, but she was very persistent for a few months. The discussion finally ended when Amy and I informed her that it was not going to happen at this time.

A couple months ago, my Rotary Club agreed to participate in an exchange-student program and needed host families for a student for the upcoming school year. The only additional information our club knew was that the student was a girl and each family would host for about three months. After discussing with Amy, we agreed to open the conversation up again with our three daughters.

I personally thought this would be a very easy conversation. Tatum, our youngest, who would be impacted most by giving up her bedroom, was emphatically onboard. Megan, our middle daughter, was completely against the idea. She was very concerned about having an extra person in our home and felt that would be very strange. Kayla, the original ring leader, was quiet and very noncommittal.

After a couple days of discussions, everyone warmed up to the idea and agreed to host an exchange student. Since then, we have learned that her name is Valeria, and she is from Sicily, Italy. We have exchanged information and photos with Valeria and her family. We are all very excited to meet her this August.

Chad Rudy, CFP®