RETIREMENT INVESTMENT ADVISORS, INC.

3001 United Founders Blvd.
Oklahoma City, OK 73112
(405) 842-3443
(800) 725-4530

9555 Lebanon Road
Suite 302
Frisco, TX 75035
(972) 377-2850

left to right: Brenda C. Bolander, Joe Bowie, Randy Thurman, Chad Rudy, Carol Ringrose Alexander, and Andrew Flinton

Financial Briefs

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Bond Strategies for Varying Goals

The strategies used for bond investing will depend on the financial objectives you are pursuing. Consider these financial objectives and bond strategies:

- **Earning interest while preserving principal.** This is the most typical role for bonds and is usually accomplished with a buy-and-hold strategy. With this strategy, you purchase a bond and hold it to maturity, looking for the highest return potential for a given time frame within a comfortable risk level. By holding the bond to maturity, you don't have to worry about interest rate changes impacting your bond's price.
- **Maximizing income.** Since bonds with longer maturities typically have higher interest rates, this strategy commonly involves investing in longer-term bonds. Interest rate changes will have a bigger effect on a longer-term bond's price because long-term bonds have a longer stream of interest payments that won't match current interest rates. Someone looking to maximize income will also be more likely to sell a bond before maturity to lock in capital gains. Another strategy to help achieve this objective is to invest in high-yield bonds, which are bonds with lower credit ratings. Due to the lower rating, these bonds often must offer higher interest rates to obtain investor interest.
- **Managing interest rate risk.** One of the most significant bond risks is interest rate risk, or the risk that interest rate increases will cause a decrease in your bond's price. Bond ladders can help manage this risk. A bond ladder is a portfolio of bonds of similar amounts maturing in several different years. When one of the bonds matures, the principal is reinvested in another bond at the bond ladder's longest maturity. By spreading out maturity dates, you lessen the impact of interest rate changes. Holding the bond to maturity prevents interest rate changes from resulting in a loss when you sell the bond. Since these bonds would mature every year or so, your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal maturing every year or so to reinvest at higher rates. In a declining interest rate market, you have some funds in longer-term bonds with higher interest rates. But the main advantage is you don't continue to hold only short-term bonds while you wait

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Bonds and Your Retirement Portfolio

For years, bonds have been an investment cornerstone for retirees because of their perceived stability, security, and ability to provide a reliable source of income. Below, we review some of the reasons you might want to make bonds part of your retirement portfolio and also highlight a few pitfalls you should be aware of.

Why Bonds for Retirement?

Compared to equities (or stocks), bonds have a reputation as a relatively conservative investment. While bonds come with some risks, the income they generate is predictable. That's why they're known as fixed-income investments. Plus, you'll get your principal back when the bond reaches maturity, assuming all goes well and the bond issuer doesn't default. That predictability is appealing to many retirees who are looking for the confidence that they'll have the money they need to meet all their expenses after they stop working.

Bonds can also offer tax advantages, which may be especially

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Bond Strategies

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for interest rates to peak, an event that is difficult to predict.

- **Help reduce the volatility of stock investments.** The advantage of including both stocks and bonds in your portfolio is that when one category is declining, the other category will hopefully help offset this decline. One way to assess the percentage of bonds to include in your portfolio is to look at how holding varying percentages of stocks and bonds would impact your average return.
- **Investing for a specific future goal.** Because bonds have a definite maturity date, you can select maturity dates to coincide with when you need your principal. You might want to consider zero-coupon bonds for this purpose. Zero-coupon bonds are issued with a deep discount from face value and do not pay interest during the bond's life. The return results from the bond's price increasing gradually from the discounted value to face value, which is reached at maturity. The longer a zero-coupon bond has until maturity, the greater its price discount will be. Like other fixed-income investments, a zero-coupon's price moves up when interest rates fall and down when rates rise. However, since zeros lock in a fixed reinvestment rate of return, they are affected more drastically by interest rate changes. One important fact to consider is taxation. Even though you do not receive any interest income until the zero-coupon bond matures, you are taxed on the yearly growth in the zero's value (called accretion).
- **Recognizing a loss for tax purposes.** A bond swap, which is simply the sale of one bond and the purchase of another, can help achieve this objective without changing the basic composition of your bond portfolio. In essence, you sell a bond with a current market value less than your purchase price to realize a loss and deduct it on your tax return. You then use the proceeds to purchase a similar bond. The end result is that you still own a comparable bond, but you also claim a tax loss. Review the cost of the swap before executing the transactions to ensure costs don't offset most of your expected tax savings. Make sure to comply with the wash-sale rules or your loss won't be deductible. A wash sale occurs when an investor sells a security, and within 30 days before or after, purchases a substantially similar security. Bonds purchased within the 30-day window must differ from the bonds sold in a material way, which includes different issuers, coupon rates, or maturity dates.
- **Reducing income taxes.** One strategy would be to invest in municipal securities, since municipal bond interest is generally exempt from federal, and sometimes state and local, income taxes. Your marginal tax bracket is a major factor when deciding whether to include municipal bonds in your portfolio. Thus, you should compare a muni bond's yield to the after-tax yield of a comparable taxable bond. To do that, calculate the muni bond's taxable equivalent yield. If you're not investing in a municipal bond issued in your resident state, the calculation is: the taxable equivalent yield equals the tax-exempt interest rate, divided by one, minus your marginal tax bracket. For instance, if you are considering a municipal bond with a yield of 4.5% and you're in the 25% tax bracket, the taxable equivalent yield is 6.0% (4.5% divided by 1 – 25%). Thus, you should compare 6.0% to any corporate bonds you are considering.

Please call if you'd like help developing bond strategies to pursue your financial objectives.

Why Do You Need Bonds?

Why should you consider bonds for your investment portfolio? The primary reasons include:

- **Bonds add diversification to your portfolio.** One strategy to help counter the effects of stock market volatility is to add investments to your portfolio that aren't highly correlated with the stock market. Historically, stocks have a low positive correlation with corporate and government bonds.
- **Bonds offer fixed, periodic interest payments and the return of your principal at maturity.** Thus, even in the event of a significant market decline, you receive some return in the form of interest payments, and you will receive your principal at maturity.
- **Bonds are often better suited to short- and medium-term financial goals.** If you need your money in a few years, you may not want to keep those funds in stocks, since a major stock market decline could occur when you need your money.

Most investors will hold stocks, bonds, and cash in their investment portfolios. How much you should allocate to the bond portion will depend on your circumstances; but over time, that percentage is likely to change. For instance, young investors are likely to be more concerned with growth, so bonds may only make up a small percentage of their portfolio. On the other hand, those who are retired or close to retirement are likely to own a higher percentage of bonds as safety of principal and a steady income stream become more important. In general, the percentage of bonds you own should increase as you become more averse to putting your capital at risk. Please call if you'd like to discuss the role bonds should have in your investment portfolio.

Your Retirement Portfolio

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appealing to retirees. Since you won't pay federal income tax (and in some cases, state and local tax) on income from municipal bonds, including some of these investments in your retirement portfolio may be a way to generate much-needed income while also keeping your tax burden as low as possible.

Most people who invest end up with some of their portfolio in bonds, since they are a good way to provide diversification. If you are including bonds in your retirement portfolio, you will likely want to diversify your holdings, just as you would with stocks. Treasuries and highly rated corporate and municipal bonds may help generate income without taking on too much risk. Lower-rated bonds can generate more income, but there's a greater chance of default.

Bonds: How Much?

Given the perceived advantages of bonds — predictable income, less risk of steep losses, and tax perks — you may be wondering not *if* you should invest in bonds, but rather *how much* of your retirement portfolio should be made up of bonds. That's a tough question. Traditionally, financial experts have urged people to focus on investing in equities when they are younger to earn as high a return as possible while they are able to take on more risk. Once people get closer to retirement, the conventional advice is to move to more bond-heavy portfolios for all the reasons discussed above. But recently, some have challenged this conventional wisdom.

One problem with bonds is that they tend to have less-impressive returns than stocks. In some ways, that's good for retirees who tend to be looking for stability, not growth. But it can present a hidden hazard especially when interest rates are low, as they are now (and have been for some time). Low interest rates mean that retirees aren't earning much on their bond investments. And when you combine low earnings with creeping inflation, you may actually end up losing money. In turn, that can cause you to draw down your retirement portfolio faster than expected, creating a risk that you'll run out of money.

Another problem with the relatively low yields on bonds? Because people are living longer, they often need a plan to make their portfolio last for three or four decades after they retire. Some retirees may still need to generate significant returns from their investments if they are anticipating retiring at 65 and living to age 95 or 100.

So what's the solution? There's no easy answer. Retirees need to strike a balance between preserving the wealth they've earned so they can live well for decades with the need to generate enough income to sustain their lifestyles. Please call if you'd like to discuss this in more detail.

Bond Investing Tips

Consider the following tips if bonds are part of your investment portfolio:

- **Determine your objectives before investing.** Decide how much of your portfolio you want invested in bonds.
- **Diversify your bond holdings among different bond types.** Consider government, corporate, and municipal bonds, as well as different industries, credit ratings, and maturities.
- **Understand the risks that affect bonds.** The most significant risk is interest rate risk. When interest rates rise, bond values fall, while values rise when interest rates decline. Other risks include default risk, or the possibility the issuer will redeem the bond before maturity; and inflation risk, or the possibility that inflation will outpace the bond's return.
- **Choose bond maturity dates carefully.** When you'll need your principal is a major factor, but the current interest rate environment may also affect your decision. Rather than investing in one maturity, you may want to stagger or ladder the maturity dates in your portfolio.
- **Follow interest rate trends.** At a minimum, follow the prime rate, Treasury bill rates, and Treasury bond rates. Understand the significance of the yield curve and track its pattern over time. By monitoring current interest rate levels, you will be able to evaluate the appropriateness of an interest rate for a specific security.
- **Compare interest rates for specific bonds before investing.** Interest rates can vary substantially among different bond types and among bonds with different maturities or credit ratings.
- **Research a bond before purchase.** Review the credit quality, coupon rate, call provisions, and other significant factors. Determine whether the bond is appropriate for you in terms of risk, return, and maturity date.
- **Consider the tax aspects.** By comparing the after-tax rate of return for various types of bonds, you may be able to increase your return. Depending on the bond, the interest income may be fully taxable or exempt from federal and/or state income taxes.
- **Review your bond holdings periodically.** Evaluate the credit ratings of all your bonds at least annually to ensure the quality hasn't deteriorated. Also, ensure your holdings are still consistent with your overall investment objectives and asset allocation plan.
- **Call for assistance with your bond holdings.** You should use carefully designed strategies to make bond decisions. Please call if you need help.

News and Announcements

From the Alexander Household

Reading *The Miracle Morning: The Not-So-Obvious Secret Guaranteed to Transform Your Life (Before 8 AM)* by Hal Elrod was the key to creating a sustainable morning ritual. It takes several elements that I was previously utilizing haphazardly. By combining them, I wake up before my alarm, which is a new experience.

You can customize Hal's model so that it works for you. He calls the elements Life SAVERS: Silence, Affirmations, Visualization, Exercise, Reading, and Scribe (journaling). Ideally, you spend 10 minutes or more on each activity, but if you only have six minutes, you can spend a minute on each.

I've added meditation and writing about Gratitudes (five things I'm grateful for), Gifts (unexpected opportunities), and Gains (accomplishments). If I don't have time in the morning, I look for time during the day to complete my ritual. By taking time for myself, I find I have more energy for others.

Focusing on gratitude has a multitude of benefits. As Tony Robbins says, "The fastest way to feel connection, a sense of how significant your life is, a deep sense of certainty and variety, and to put yourself in a state where you can give to others, is to find a way each day to appreciate more and expect less."

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

From the Rudy Household

Exactly two years ago, my newsletter article was about getting involved in local politics in which the decisions directly impact your community and the policy makers are more easily accessible. This past February, I took my own recommendations to heart and ran for the public office of Frisco Independent School District Board of Trustee (a.k.a. School Board). I am a fairly private person, so running for an elected position is something I was certain I would never do.

Though I had two opponents, the campaign was relatively respectful. However, it was still a campaign and it was very interesting as the different factions within the city aligned with each candidate. During the campaign, I met hundreds of new people through mutual friends, at campaign events, and while greeting voters at the polls. On Election Day, it was a unique feeling to rely on thousands of people to cast their vote deciding that you are the best candidate.

I am happy to announce that on May 9, I was elected to the FISD Board of Trustees. There was not much rest after Election Day before training and meetings began. I recognize that this is a tremendous responsibility, and I am looking forward to serving the school district and my community.

Chad Rudy, CFP®

From the Bolander Household

Leadership Northwest is an outstanding program that allows participants to network with Northwest Oklahoma City civic, nonprofit, and business leaders and learn about various organizations in our community. During the last several months, I had the privilege of participating in the program. Each meeting has had a specific theme, such as services offered by city, county, and state governments and the host of nonprofit organizations that help the underprivileged in our area and how to become involved. We visited some of the great medical and educational facilities here, and I jumped to the head of the class when it came time to slide down the pole in the Bethany Fire Station — that was fun!

For our class project, we teamed up with the nonprofit OKC Harvest to build raised vegetable gardens at the Rockwell Plaza YMCA. With all the rain we had in May, that project could have been a lost cause, but recent pictures from the Y director show that the gardens are doing very well and will benefit the community for a long time to come. The Leadership NW program was a great experience and I highly recommend getting involved if you can.

Have a great summer,

Brenda C. Bolander, CFP®, CPA/PFS

Holiday Closing

Our office will be closed Friday, July 3, in observance of Independence Day.