CONSULTANT'S CORNER

—— ♦——

E. JEFFREY ROOF

Bonds *are* boring but …

My wife told me not to write this article. Her comment was, "Nobody cares about bonds." And she's partially right.

Bonds are the brussel sprouts of a balanced portfolio. About as appealing to the masses in the past several years as value-investing. But bonds, Buffet, and perhaps even brussel sprouts, will eventually return to favor.

It is not surprising that bonds have been considered passé by a large portion of the investing public. Recent comparative returns between stocks and bonds have not even been close because of the stock market's euphoric performance. That has prompted many investors to forego some of the downside protection offered by bonds in favor of the upside potential offered by stocks.

Additionally, until the past several months, very little of the stock market's downside had been seen for years.

Basically, for most investors, bonds just aren't sexy. When was the last time you overheard someone bragging about the great price they paid for a Ginnie Mae? Or the last *Moneyline* broadcast discussing the potential benefits of escrowed-to-maturity municipal bonds. Cocktail conversation this is not.

Bonds just don't have the sizzle of stocks, but, given the right scenario, this can be their greatest attraction.

The dramatic gyrations in stock prices during the past several months and the accompanying increase in interest rates has prompted many investors to reexamine bonds as a complement to their equity holdings in an effort to temper portfolio volatility and stabilize return.

Let's review some of the bond basics and address several of the myths:

Are Bonds "Safer" Than Stocks?

It depends on your definition of safety. In the strictest technical interpretation, the answer is "yes". The repayment of debt to bondholders takes precedence over returning the investment of equity to stockholders.

For example, if you own a bond issued by General Motors and I own General Motors common stock, the obligation to repay your bond will be given priority over the return of my investment.

However, the question of "safety" becomes more complex when moving beyond this straightforward illustration. For instance, being a common stock shareholder in a large, well established utility firm might actually be less "risky" in terms of losing invested principal than being a bondholder of a small, start-up, dot.com company. It is important to remember that the guarantee to repay a bond is only as strong as the entity issuing the bond.

Is My Money Stable When Invested in Bonds?

Yes and no. With most bonds, you receive the full face value of that bond when it matures. However, between issuance and maturity, bonds typically can be bought and sold at prices determined by market conditions. If sold before maturity, you may receive less (or more) than the face value of that bond.

For example, previously issued U.S. Treasury bonds maturing in 2005 are available at a 12% coupon rate. Sounds like a great deal, since 12% is a much higher interest rate than available currently.

However, the cost of a $50,000 U.S. Treasury as described above is approximately $61,000, a 22 percent plus premium. Consequently, the yield on your actual investment would be approximately 6.5%, not the bond's coupon payment of 12%. Likewise, bonds with coupons paying less than market rate are sold at a discount.

As a result, the value of a bond portfolio or bond-oriented mutual fund will fluctuate overtime. Because bond funds have no set maturity date, there is no assurance your invested principal with remain consistent.

Why Not Get The Highest Yield Possible?

As in all investing, potential reward walks hand in hand with potential risk. The higher the yield, the higher the risk. Two key factors that influence the yield to bondholders are the ability of the borrowing equity to repay the debt (safety) and the time until the debt is repaid (maturity).

When using US Treasury Bonds, the US Government guarantees your investment. At the other end of the spectrum, corporate assets guarantee a bond issued by XYZ Inc. XYZ will have to pay a higher yield to compensate investors' for the higher risk.

Similarly, longer-term bonds will often, but not always, pay a higher yield than shorter-term bonds. The increased risk associated with a longer-term investment can include the uncertainty of future interest rates and economic health of the issuing entity.

A Bond Fund or Individual Bonds?

This depends. My firm tends to use individual bonds because of the ability to tightly control quality, yield, maturity, and income stream while customizing a portfolio for an investor's specific profile and situation. For smaller investors, buying a bond fund provides a level of diversification that would not be possible through individual issues.

Many of the caveats that apply to stock fund investing are also appropriate. First, understand the underlying assets. What portion of a U.S. Government bond fund is actually invested in U.S. Government bonds? What is the average maturity of the fund's bond portfolio? A fund that increases current yield by using high risk, long-term bonds can be unexpectedly volatile if interest rates rise.

Look carefully at a bond fund's advertised "yield", particularly taxable bond funds. Some bond funds include more than interest earned in this calculation, inflating the perceived return. Remember, if it sounds too good to be true, it most likely is.

For example, a client recently shared that when looking to buy a quality four year corporate bond paying a market appropriate rate of close to 8%, a broker suggested a bond fund "currently yielding 13% and just as safe" as an alternative. Hmmmmmm.

Also, carefully review any bond fund's commission structure and expense ratio. High expenses can dramatically reduce overall return. Recently we reviewed a portfolio holding a PA municipal bond fund with an outlandish expense ratio of 1.5%. Yikes. Though the fund's 4.5% yield was comparable to other similarly invested funds, overcoming those high internal costs was akin to filling a leaking bucket.

Bonds can be used effectively to balance equity risk and temper portfolio volatility in the proper situation. Don't overlook their potential because of their lack of pizzazz.

E. Jeffrey Roof is president of Roof Advisory Group, an independent investment management and financial planning firm based in Camp Hill. The firm is a fee-only Registered Investment Advisor that manages assets and preserves wealth for individuals & institutional clientele. The firm's e-mail address is roofadvisory@earthlink.net.