

CONSULTANT'S CORNER



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Fixed-income investments could reduce portfolio risks

Fixed-income management has always been an important component of a balanced portfolio. But the stellar returns produced by equity investing during the past several years, coupled with the huge bond market swings and junk bond disasters of the 1980's, placed fixed income investing out of favor with much of the public.

Now, the recent gyrations of the stock market have generated renewed interest in fixed income investing among individual investors.

Using bonds and other fixed income investments as part of your portfolio strategy can effectively reduce your overall risk. It can also have the opposite effect. Here are some basic questions and answers:

Q: What are fixed income securities?

A: Basically, fixed-income securities pay a specified amount of income during a defined period of time. The most familiar fixed income investments are types of bonds. Other examples include convertible preferred stock, mortgages, and commercial paper.

Certificates of deposit and annuities are occasionally considered fixed income type investments because of certain similarities.

When you buy a bond, you are essentially purchasing the obligation of that bond issuer to repay you the value of the bond and interest at a specified time.

Q: Do all bonds pay current interest?

A: Most bonds pay a defined rate of interest at specified times during the year. The exceptions are "zero-coupon" bonds that pay interest in one lump sum at maturity.

Two key factors that influence the interest rate paid to bondholders are the ability of the borrowing entity to repay the debt (safety) and the amount of time until the debt is repaid (maturity). Current and projected interest rates, as well as economic and market conditions, impact the rates paid to bond investors.

Q: Are bonds safer than stocks?

A: In the strictest technical terms, yes. If you own a bond issued by XYZ Corp. and I own XYZ common stock, the obligation to repay your debt will be given priority over the return of my investment. Simply put, the company is indebted to you and, as a shareholder, my invested dollars are at risk to cover that debt.

However, the question becomes more complex when moving beyond this straightforward illustration. For example, owning common stock 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 company.

The guarantee to repay a bond is only as strong as the borrower.

Q: Is my money stable when invested in a bond?

A: When you buy most individual bonds, you will receive the face value of that bond if it is held until maturity. However, between issuance and maturity, most bonds can be bought and sold at prices determined by market conditions.

If you buy or sell a bond before maturity, you may receive less (or more) than the face value of the bond.

For example, previously issued U.S. Treasury bonds are available that pay an interest rate in excess of 13 percent and mature in 2001. However, to buy a \$50,000 bond at that rate would require you to pay in excess of \$60,000, a 20-plus percent premium.

The actual yield on your invested dollars would be about 4.6 percent, not the bond's coupon rate of 13 percent. Likewise, a bond paying less than the current available interest rate would have to be sold at a discount.

Q: Why not get the highest yield possible?

A: As in all investing, potential reward walks hand in hand with potential risk. In this case, reward can be defined as the yield on your investment. Risk can be defined as the relative safety of your invested principal or the likelihood your fixed income investment will pay competitive market rates going forward.

US Treasury Bonds, backed by the federal government, set the worldwide standard of financial security. The safety of your invested principal is guaranteed by the United States.

At the other end of the spectrum, a bond issued by XYZ Corporation guarantees your principal by its ongoing successful operation and the assets of their firm. They will have to pay a higher yield to compensate investors' for the higher risk.

Similarly, longer-term bonds will typically pay a higher yield than shorter-term bonds. The increased risk associated with a longer-term investment can be the uncertainty of future interest rates and economic health of the issuing entity.

Having addressed the basic questions, allow me to note that it's important to thoroughly understand any fixed income investment before making a decision on its appropriateness for your situation. Here are the minimums.

• ***Understand the investment vehicle.***

Each fixed income vehicle is a bit different. For example, individual Ginnie Mae bonds, and mutual funds investing in these popular bonds, often offer attractive yields with a relatively high degree of safety.

However, carefully review any return percentage advertised for Ginnie Mae funds. In most cases, the advertised return is not from yield alone.

Ginnie Maes periodically distribute both invested principal and interest throughout their lifetime. Many investors have mistakenly exhausted their investment by assuming all their return distributions were current income.

• ***Understand the investment risks.***

Knowing the creditworthiness of a bond issuer is critical. Generally recognized bond ratings are helpful.

As an example, a Standard & Poor's rating of BBB and better is considered investment grade. However, ratings aren't fool-proof and the prudent investor will look deeper. This is particularly true when investing in fixed income mutual funds.

What portion of a U.S. government fund is actually invested in U.S. government securities? 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.

• ***Understand the investment costs.***

Knowing what and how you are paying in the form of costs is critical in determining the net benefit of any investment. Some individual fixed income investments receive "haircuts", reductions in yields that are used to compensate the bond seller.

Compare the expense ratios of fixed income mutual funds carefully because high internal operating expenses can dramatically reduce the net return realized in bonds.

Annuity products often have significant costs that need to be clearly understood before deciding whether they offer your best investment alternative. The much touted tax-deferral advantage can quickly disappear when mortality and sales expenses are netted from your expected return.

The bottom line is if you are using fixed income investments to balance equity risk and temper portfolio volatility, make sure you are accomplishing that objective. Seek quality fixed income investments and avoid lowgrade securities that can actually increase volatility and potential loss of principal. Trying to duplicate the recent returns of the stock market with fixed income investing will doom you to repeat the mistakes many investors made the last time bonds were in vogue.

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