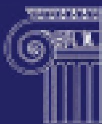
SUMMER 2006



BACK BAY FINANCIAL GROUP

HELPING CLIENTS BUILD AND MANAGE WEALTH ™

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THE BACK BAY ADVISOR

Back to Basics with Bonds

With the future direction of interest rates uncertain, you may wonder whether now is a good time to invest in bonds. If you are reassessing your bond investments, consider the following:

Decide how much of your portfolio to allocate to bonds. Whether you're shifting funds between stocks and bonds, rebalancing your portfolio, or setting up an investment strategy, decide how much of your total portfolio to invest in bonds. Your allocation to the bond portion of your portfolio will depend on your personal situation, but over time your percentage of bonds is likely to change. In general, the percentage of bonds you own should increase as you become more averse to putting your capital at risk.

Understand your objectives for your bond investments. Many investors purchase bonds for a dependable income stream and to protect their principal. These investors will typically buy and hold bonds until maturity. They are looking to maximize yield for a given time frame with a comfortable risk level. Other investors prefer to use bonds to reduce risks in a portfolio heavily weighted with stocks or to actively trade bonds for capital gains. These investors will assess the likely future direction of interest rates in conjunction with other factors. Each type of investor will use different strategies for bond investments.

Determine maturity dates you are interested in. Your best approach may be to select a maturity date that coincides with when you need your principal. Otherwise, if you have to sell before maturity, fluctuating interest rates and transaction costs may leave you with less than you expected. Before deciding on a maturity, review the yield curve to see if there are advantages to selecting a slightly longer or shorter maturity. You may find that increasing the maturity date by a couple of years will increase your return or that committing your funds for a long time does not bring much additional return.

Evaluate different types of bonds. Consider your personal situation and risk tolerance. Treasury securities are the safest type of bond, since they are guaranteed by the U.S. government. However, they also typically have the lowest yields. Interest income is usually exempt from state and local income taxes, but is subject to federal income taxes. Government issued inflation-indexed bonds may be of interest to long-term investors who are concerned that inflation will erode their investments' purchasing power. Investors in higher tax brackets should review municipal bonds, since the interest income is typically exempt from federal income taxes and may be exempt from state and local income taxes. However, municipal bond income may be subject to the federal alternative minimum tax (AMT) and capital gains from sales of municipal bonds may be subject to taxes. Keep in mind that municipal bonds are subject to market risk, interest rate risk, and credit risk. Corporate bonds usually carry more risk, but also typically offer higher returns. Interest income from corporate bonds is subject to federal and state income taxes. Interest rates can vary significantly among different types of bonds and among bonds with different maturities or credit ratings. However, different types of bonds do not always respond to interest rate changes with the same magnitude. Before purchasing a bond, review the historical spread in yields between two different types of bonds. This can reveal whether the bond's yield is attractive compared to another type of bond.

Diversify your bond portfolio in several ways. You can select different bond types, issuers, maturity dates, coupon yields, or credit ratings. All of these factors add diversification to your bond portfolio.

Consider laddering your bond portfolio. A bond ladder is a portfolio of similar amounts and types of bonds, which mature at several different dates. For instance, a $30,000 portfolio might consist of six issues of $5,000 each, maturing in six consecutive years. Since the bonds mature every year or so, you

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What's Happening with Long-Term Interest Rates?

Since June 2004, the Federal Reserve has increased the federal funds rate and the discount rate, two very short-term interest rates, 16 times in .25% increments, increasing from 1% to 5% and 2% to 6%, respectively. It was widely anticipated that long-term interest rates would follow this trend and increase as well. Instead, long-term interest rates are hovering close to where they stood in June 2004. For instance, the 10-year Treasury note had a yield of 4.5% in June 2004 and 5.1% in May 2006.

This situation seems puzzling because the yield curve is typically upward sloping. A yield curve is a graph plotting interest rates for the same type of bond for a series of maturities, typically ranging from three months to over 25 years.

An upward-sloping yield curve means that long-term rates are higher than short-term rates. Currently, however, short- and long-term interest rates are almost the same, making the yield curve almost flat. A flat yield curve typically indicates that an economic slowdown and lower interest rates will follow. How unusual is this response to short-term rate increases?

A study by the Federal Reserve Bank of Kansas City reviewed the nine times during the past 40 years when short-term interest rates were increased by the Federal Reserve. In two of those nine instances, including the current situation, the 10-year interest rate actually declined at the beginning of the policy tightening. The conclusion of this study was that long-term rates have not increased because inflation concerns for the long term are minimal, and there is increased demand for longer-term securities. Since expectations are that the Federal Reserve will keep inflation under control, long-term rates contain less of an inflation component. However, the study was not sure why demand for long-term securities had increased (Source: *Economic Review*, Fourth Quarter 2005).

Another review, this one published in the *Federal Reserve Bank of St. Louis Review* in September/October 2005, found that since 1984, a 1% increase in short-term rates has resulted in a .32% increase in the 10-year bond rate. However, in the current situation, long-term inflation expectations, measured by comparing conventional and inflation-indexed bonds, have not changed much. This is a result of confidence in the Federal Reserve's policies to keep inflation under control.

If you would like to discuss how this may impact your bond investments, please call.

Why Do Bond Prices Fluctuate?

If you hold a bond to maturity, you receive the full principal amount. However, if you want to sell before maturity, your bond will probably sell at a premium or discount to that amount. Why do bond prices fluctuate? There are two primary reasons:

Credit rating changes — 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. The first four rating categories are considered investment-grade bonds, while the lower categories are considered speculative. A bond's rating affects the borrowing cost for the issuer. 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 will decline when a rating is downgraded and will increase when a rating is upgraded. The price change brings the bond's yield in line with other bonds with a similar rating. However, these price changes are typically minor if the rating changes by only one notch. Certain downgrades are more significant, so you should review whether you want to continue to hold the bond if:

- A downgrade moves a bond from an investment-grade to a speculative rating.
- A downgrade of more than one notch is made.
- A series of downgrades occurs over a short period of time.

Interest rate changes — Interest rate changes will typically cause a bond's price to fluctuate more than credit rating changes. When interest rates rise, a bond's price will decline, while the bond's price will increase when rates decrease. For instance, assume you own a 10-year bond that pays a 3% coupon, while bonds of the same maturity currently pay 4%. It would be difficult to find someone willing to pay the full principal amount to receive 3% interest, when they could easily purchase another bond with 4% interest. To encourage someone to purchase the bond, you would have to lower the price enough so the bond pays the equivalent of 4%.

To extend the example further, suppose you own two bonds paying 3% — one with a five-year maturity and another with a 10-year maturity. Would you be able to get the same price for both bonds? Since the bond with the 10-year maturity is paying a lower interest rate for a longer period, you would have to discount that bond more. 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.

Before selecting a maturity date for a bond, consider when you will need your principal. If you sell before the bond matures, interest rate and credit rating changes will affect the selling price. Please call if you'd like help with your bond portfolio.

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reinvest the proceeds over a period of time rather than in one lump sum. If rates increase, you have money every year or so to reinvest at the higher rates. With declining rates, you have some funds invested in longer-term bonds.

Review the use of bond swaps, where appropriate. A bond swap is simply the sale of one bond issue and the purchase of another. Swaps take advantage of inefficiencies in the bond markets and between different bonds. One of the more popular bond swaps is the tax swap, which realizes losses on a bond for tax purposes. In essence, you sell a bond with a current market value less than your purchase price to realize the loss and deduct it on your tax return. You then use the proceeds to purchase similar bonds. The end result is you still own a comparable bond, but you also have a tax loss. Review the cost of the swap before executing the transactions to ensure the 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 tax deductible. A wash sale occurs when an investor sells a bond, and 30 days before or after the sale, purchases substantially the same 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.

Use duration to help manage interest rate risk. Interest rates and bond prices move in opposite directions, which can significantly affect a bond's market value. However, it is often difficult to determine what impact a given interest rate change will have on a specific bond, since maturity date, credit ratings, coupon rate, and current interest rates all affect the result. Duration can be a helpful tool in estimating the expected impact of interest rate changes on your bond portfolio. Duration calculates how much a bond's price will move for every 1% change in interest rates. A bond's duration is typically shorter than its maturity. You can set an overall target duration for your portfolio, so you'll have a reasonable estimate of how your bond portfolio will fluctuate with interest rate changes.

Remember the basics. In general, rates of return reward you for the risks you assume. If prevailing interest rates are 4%, a bond paying 7% probably carries some additional risk. Make sure you understand that risk before purchasing the bond. Evaluate your entire portfolio periodically to ensure your bonds still meet your investment objectives. Changes in credit ratings or other events can significantly affect your bonds' values.

Various strategies can be used with your bond investments. Please call if you'd like help deciding which are appropriate for your circumstances.

What Are Convertible Bonds?

Convertible bonds are a hybrid investment, combining features of both stocks and bonds. Like all bonds, convertibles pay a fixed interest rate for the bond's life, with the principal returned at the end of the bond's term. However, convertible bonds can also be exchanged for a specific number of shares of the issuing company's common stock.

The bond's interest payments are typically higher than the dividends paid on the common stock, but the interest rate is usually lower than that on nonconvertible bonds. However, the ability to convert to common shares allows investors to participate in share price increases without as much exposure to share price decreases. Convertibles do not decline as much as the common shares, because the bond retains a market value equal to comparable bonds paying the same yield, which acts as a floor for the convertible's value.

When issued, the convertible bond's value exceeds the common stock's price by an amount known as the conversion premium, which changes as the stock price changes. If the stock is selling below the conversion equivalent, there is no financial incentive to convert the bond, so its price will be primarily determined by factors affecting bonds. Once the stock's price rises enough to provide a profit by converting the bond, the stock's value will primarily determine the convertible's market value.

Most convertibles can be called back by the issuer at a specific price. These call provisions are typically used by the issuer to force investors to convert the bond to common stock so the debt obligation can be eliminated.

Since they are a hybrid investment, convertible bonds can be difficult to evaluate. You should only invest in a convertible if you like the underlying stock. Consider bond and stock pricing, current interest rates, the probability of a bond call, the convertible's yield advantage over common stock, the convertible's fixed-income value, and the volatility of the underlying stock.

Convertible bonds can be appropriate investments for investors who want to slowly ease into the equity markets or who are concerned about potential stock market corrections. If you'd like to discuss convertible bonds in more detail, please call.

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