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How to Build and Manage a Bond Portfolio

Bonds have three basic purposes in a portfolio: to diversify a stock portfolio, to maximize total return, or to generate income. Depending on your objective, there are several strategies open to you.

Diversifying a Stock Portfolio

Adding bonds to a stock portfolio is one of the main ways to reduce investment risk. Bonds accomplish this because their performance cycle is generally out of sync with the ups and downs of the stock market. In years when stocks are performing poorly with weak or negative returns, bonds may be outperforming stocks.

In fact, that was the case in six out of the last 13 years. In three of those years, bonds (as represented by the Barclays Aggregate Index) were the top-performing asset class; and in two of the years, bonds achieved returns that exceeded the long-time average of 10% for S&P 500 stocks. Looking into the previous decade, in 1995, bonds returned 18.5% and twice returned more than 9%. Meanwhile, bonds lost money for investors only twice in the last 20 years (-2.9% in 1994 and -0.8% in 1999), while stocks lost money in four years, with losses ranging from -9.1% to -37.0% (Source: Callan Associates, Inc., 2013). *These returns are presented for illustrative purposes only and are not intended to project the performance of a specific investment vehicle. Historical returns are not indicative of future returns.*

Professional money managers measure risk by a statistical value called "standard deviation," expressed as a percentage. Over the last 10 years, stocks returned a compound average annual return of 5.4% and were characterized by a standard deviation of 18.3%. Meanwhile, bonds returned an average of 4.0% with a standard deviation of 1.6%. That means that as an asset class, bonds generated nearly 80% of the return of stocks, but with less

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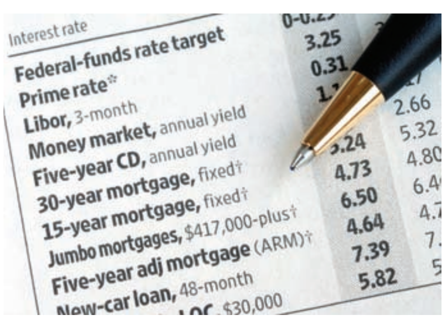

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How to Build

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than one-tenth of the risk.

By adding bonds to an all-stock portfolio over the last 10 years, an investor could have potentially achieved close to the same returns of the stock market with much less risk. Again, using the returns from the two indexes, a portfolio comprised of 60% stocks and 40% bonds would have generated nearly all of the return of an all-stock portfolio — 5.2% versus 5.4% — with 40% less risk (10.9% versus 18.3%).

When your goal is to reduce the risk of your overall investment portfolio, it's important to buy high-quality bond issues and avoid investing mainly in long maturities. Low-quality bonds and bonds with long maturities may offer higher yields, but both expose you to greater risk — junk bonds to a greater risk of default and long-maturity bonds to the risk of losing market value when interest rates rise.

Maximizing Total Return

When you want to generate a high total return over the long term, your bond objective is to generate capital gains, which you do by trading — buying and selling bonds before they mature — and reinvesting the proceeds in more bonds. Professional money managers do this in two ways: buying discount bonds and concentrating purchases of bonds in one or more specific maturities.

The prices of existing bonds change as market interest rates rise or fall. When interest rates rise, the prices of existing bonds generally go down, sometimes below their face value. Bonds priced below that benchmark are called "discount bonds." If an investor buys a discount bond and holds it to maturity at face value, the result is a profit.

Sometimes, similar price advantages emerge among bonds at specific maturities because of inefficiencies in the bond market. Professionals know that there is a pattern to the line that connects yields and maturities, known as the "yield curve." Irregularities can develop in the yield curve that suggest to professionals that prices at a specific maturity are temporarily depressed. While not actual "discount bonds," the prices of these bonds are expected to increase as the yield curve returns to its normal shape.

Generating Income

When you're positioning your portfolio, you should concern yourself with maximizing your total return in light of your tolerance for risk. But once you're retired, many people hold bonds to generate income to support their lifestyle instead of reinvesting the interest. While any portfolio structure will suffice, a "laddered" bond portfolio is often recommended.

To create a ladder, divide the total amount of capital you want to devote to generating income into five to 10 equal parts. Then, invest each amount in bonds of different maturities; and when your shortest-maturity bonds mature, reinvest the proceeds in the bonds with the longest maturity you started with.

A bond ladder's chief advantage is to keep the interest income you receive more even over the years than it would typically be if all of your bonds mature at the same time. When all of your bonds mature, how much income you generate depends on the rates that prevail at the time. With a ladder, you still control your risk level through the quality of the bonds in which you invest and in the average maturity of the entire portfolio you create.

Your stage in life, your risk tolerance, and your needs for income or total return are all important factors in the structure of the bond portfolio that's right for you. Please call your financial advisor if you would like to discuss this in more detail. ❍❍❍

A Budget for Your College Student

Many students will first handle money without parental supervision during college. To help keep expenses down and avoid conflicts, you might want to develop a budget to guide your child's spending. Consider the following:

✔ First consider all potential expenses, including food, travel, clothing, entertainment, phone, periodicals, computer expenses, medical and dental expenses, and insurance.

✔ Develop a preliminary budget for the first couple of months of college. After your child has lived on his/her own for a couple of months, you can develop a more realistic budget.

✔ If your child has trouble sticking with the budget or can't account for large sums, have him/her keep a journal for a couple of weeks that details all expenditures. Review the journal to find ways to reduce expenses.

✔ Consider providing your child with a debit card. Since your child's spending will be limited to the amount on deposit, it is harder to overspend.

✔ Explain the basics of credit cards. Make sure your child doesn't use a credit card as a means to overspend. Go over which types of items your child can use the credit card for and which items should not be charged. Make sure your child understands that if the balance isn't paid in full each month, a significant amount of interest will have to be paid on the outstanding balance.

✔ Have your child provide you with a written comparison of his/her actual expenses to budgeted amounts. ❍❍❍

An Investment Plan Should Be a Living Document

If you've ever completed an investment plan, you know how much work it is to prepare. So, after all that work, you're done, right?

Wrong. The world is constantly changing, the markets are constantly fluctuating, and so is your life. If your plan for the future is going to be of any real use, it has to reflect those changes, too. Instead of a static document, your investment plan needs to be like a dramatic series: a script that changes with times.

How often should you revise your plan? The easy answer is this: whenever there's a major change in your life circumstances — a birth or a death, a promotion and a raise or the loss of a job, or a wild gyration in the stock or real estate markets. The truth is, though, even without those major events, an annual review is a good idea. Let's take a closer look at what you'll need to pay periodic attention to:

Family changes. These include the births or adoption of children, marriage or divorce, and changes in your health or that of your partner or spouse. It could also involve changing those you name as heirs for any number of reasons, including deaths, births, or simply a change in your preferences.

Career and income changes. For most people, their lifestyle today and the one they plan for retirement is closely related to their current income. If you're promoted and your income bumps up, or you change careers or lose your job, your current lifestyle is likely to change, and you might need to reset your goal for your retirement too. In fact, anything that dramatically changes your asset values — like an inheritance, the sale of a business interest, or uncovered medical expenses — could also mean it's time to reset the scope of your retirement lifestyle.

Changes in tax rates and tax laws. Over the past decade, taxation has been a particularly volatile subject, with federal and state income and investment taxes changing and big swings in estate tax provisions. These can have a major effect on the value of any strategy you may have in place, from the types of retirement accounts you have, to your strategy for harvesting taxable gains and losses, to your estate plan for minimizing taxes.

Potential changes in Social Security and health insurance. The Affordable Care Act, passed in 2010, is restructuring the health care insurance market, and most of its provisions have yet to take effect. As for Social Security, to date its benefits are linked to the rising cost of living, so it's important to stay on top of your projected benefits year by year. Meanwhile, it remains to be seen whether benefits will be restructured in the future, given the concerns over the long-term solvency of the program.

Market returns. Market volatility can wreak havoc with your plans for the future. Over the last 10 years, we've experienced two major bear markets in stocks and one of the most severe losses in average home prices in U.S. history. As a result, millions of people have had to reconsider how long they're going to have to keep working, what kind of lifestyle they should aim for, and/or how much more they need to be putting away.

Even without major gyrations in the markets, it pays to review the investment and asset components of your investment plan at least once a year. Even the best plans are based on an estimate of future rates of return applied on a straight-line basis. As result, it's more often that your actual returns will vary than that they'll hit your projections exactly.

What's important is to check your progress toward your long-term goals and remember that you're more likely to be in a marathon toward your goals than a sprint.

On the other hand, wide divergences from your trend line may mean that you need to save more, devote more of your income to other needs or goals, or need to change your asset allocation strategy.

It can be a mistake to let your investment plan sit too long unattended. Much has changed in just the past few years.

If you feel it's time to give your plan another look, please call your financial advisor. ❍❍❍

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Decisions Regarding College Funding

Before you can determine how much to save for your children's college educations, there are several decisions:

Does each child require the same level of support? While parents typically want to treat children equally, each child's needs may differ. One child may excel in school and want to attend an expensive private college, while another child may feel more comfortable at a local public university.

What is your savings goal? Setting a savings goal can be difficult if your child is many years from college. With college costs increasing so significantly in recent years, assuming similar increases in the future may make your savings goal seem overwhelming. To keep your savings amount reasonable, you can estimate your savings target based on today's college costs, increasing that amount every year to cover actual college cost increases.

Will your child contribute toward college costs? Most children would have difficulty paying for all college costs, but you may expect your children to help fund certain costs.

Will your family qualify for financial aid? Even if your child is several years from college, it is worthwhile to evaluate whether you would be eligible for financial aid. Also, be aware that many scholarships are awarded based on merit, not need.

Will you need loans to pay some college costs? By starting a savings program early, hopefully, you won't have to borrow for college. However, there are a variety of loan options available, with some of the least costly available only to students.

How much can you save on an annual basis for college? You don't have to select a fixed amount to contribute annually. You may decide to increase savings in the early years or contribute an increasing amount every year.

How will you save for college? There are a number of ways to save for college and to reduce your after-tax costs. Look into section 529 plans, Coverdell education savings accounts, education tax credits and deductions, saving in your child's name, and using IRA funds to pay college costs. Evaluate all options in light of your financial situation.

If you'd like help with this process, please call your financial advisor. ❍❍❍

Set Your Own Debt Limit

To find out where you stand with consumer debt, which includes all debt except mortgage debt, make a list of your debts and monthly payments. Then calculate your debt ratio by dividing your monthly debt payments by your monthly net income. The general guideline is that your debt ratio should not exceed 10% to 15% of your net income, with 20% usually considered the absolute maximum. However, you should consider your own circumstances and decide how much debt you want.

Before purchasing something on credit, carefully evaluate whether it makes financial sense to do so. Some questions to ask yourself include: Should I wait and save the money so I can pay cash for the item? Will the cost of the item increase or decrease in the future? Is it really worth paying interest on the item so I can use it now? Will I still be within my designated debt limits if I add this new debt payment? Will the item still have value after I finish paying for it?

Setting your own debt limit and carefully evaluating whether you should purchase an item on credit should help you keep your debt under control. ❍❍❍

Financial Thoughts

Many affluent investors are taking actions to better control their finances. One-third of a recent survey's respondents said they are living more within their means. Similarly, 32% are more vigilant about sticking to a budget. About 30% consulted their spouse more often when making financial decisions (Source: Merrill Lynch Affluent Insights Survey, 2012).

The percentage of adults fearful of not having enough money to live comfortably in retirement rose from 32% in 2002 to 66% in 2011 (Source: Gallup Poll, 2012).

In a recent survey, 57% of individuals between the ages of 21 and 31 and 51% of individuals between the ages of 32 and 46 expect to stop working before they reach traditional retirement age. However, only 31% of individuals between the ages of 47 and 57 indicated that they will quit working before age 65 (Source: "Retirement Income and Investor Types," Aite Group, 2012).

In 2012, there was still an almost 20% earnings gap between male and female full-time workers. The earnings gap is even larger in some high-skill, high-paying jobs. For instance, women doctors earn 63 cents for every dollar a man earns, while women lawyers earn 78 cents (Source: *Bloomberg Businessweek*, September 23, 2012). ❍❍❍