



Bond Investment Strategies

The way you invest in bonds for the short-term or the long-term depends on your investment goals and time frames, the amount of risk you are willing to take and your tax status.

When considering a bond investment strategy, remember the importance of diversification. As a general rule, it's never a good idea to put all your assets and all your risk in a single asset class or investment. You will want to diversify the risks within your bond investments by creating a portfolio of several bonds, each with different characteristics. Choosing bonds from different issuers protects you from the possibility that any one issuer will be unable to meet its obligations to pay interest and principal. Choosing bonds of different types (government, agency, corporate, municipal, mortgagebacked securities, etc.) creates protection from the possibility of losses in any particular market sector. Choosing bonds of different maturities helps you manage interest rate risk. With that in mind, consider these various objectives and strategies for achieving them.

Preserving Principal and Earning Interest

If keeping your money intact and earning interest is your goal, consider a "buy and hold" strategy. When you invest in a bond and hold it to maturity, you will get interest payments, usually twice a year, and receive the face value of the bond at maturity. If the bond you choose is selling at a premium because its coupon is higher than the prevailing interest rates, keep in mind that the amount you receive at maturity will be less than the amount you pay for the bond.

When you buy and hold, you need not be too concerned about the impact of interest rates on a bond's price or market value. If interest rates rise, and the market value of your bond falls, you will not feel any effect unless you change your strategy and try to sell the bond. Holding on to the bond means you will not be able to invest that principal at the higher market rates, however.

If the bond you choose is callable, you have taken the risk of having your principal returned to you before maturity. Bonds are typically "called," or redeemed early by their issuer, when interest rates are falling, which means you will be forced to invest your returned principal at lower prevailing rates.

When investing to buy and hold, be sure to consider:

- The coupon interest rate of the bond (multiply this by the par or face value of the bond to determine the dollar amount of your annual interest payments)
- The yield-to-maturity or yield-to-call. Higher yields can mean higher risks.
- The credit quality of the issuer. A bond with a lower credit rating might offer a higher yield, but it also carries a greater risk that the issuer will not be able to keep its promises.



Maximizing Income

If your goal is to maximize your interest income, you will usually get higher coupons on longer-term bonds. With more time to maturity, longer-term bonds are more vulnerable to changes in interest rates. If you are a buy-and-hold investor, however, these changes will not affect you unless you change your strategy and decide to sell your bonds.

You will also find higher coupon rates on corporate bonds than on U.S. treasury bonds with comparable maturities. In the corporate market, bonds with lower credit ratings typically pay higher income than higher credits with comparable maturities.

High-yield bonds (sometimes referred to as junk bonds) typically offer above-market coupon rates and yields because their issuers have credit ratings that are below investment grade: BB or lower from Standard & Poor's; Ba or lower from Moody's. The lower the credit rating, the greater the risk that the issuer could default on its obligations, or be unable to pay interest or repay principal when due.

If you are thinking about investing in high-yield bonds, you will also want to diversify your bond investments among several different issuers to minimize the possible impact of any single issuer's default. High yield bond prices are also more vulnerable than other bond prices to economic downturns, when the risk of default is perceived to be higher.

Managing Interest Rate Risk: Ladders and Barbells

Buy-and-hold investors can manage interest rate risk by creating a "laddered" portfolio of bonds with different maturities, for example: one, three, five and ten years. A laddered portfolio has principal being returned at defined intervals. When one bond matures, you have the opportunity to reinvest the proceeds at the longer-term end of the ladder if you want to keep it going. If rates are rising, that maturing principal can be invested at higher rates. If they are falling, your portfolio is still earning higher interest on the longer-term holdings.

With a **barbell strategy**, you invest only in short-term and long-term bonds, not intermediates. The long-term holdings should deliver attractive coupon rates. Having some principal maturing in the near term creates the opportunity to invest the money elsewhere if the bond market takes a downturn.

Smoothing Out the Performance of Stock Investments

Because stock market returns are usually more volatile or changeable than bond market returns, combining the two asset classes can help create an overall investment portfolio that generates more stable performance over time. Often but not always, the stock and bond markets move in different directions: the bond market rises when the stock market falls and vice versa. Therefore in years when the stock market is down, the performance of bond investments can sometimes help compensate for any losses. The right mix of stocks and bonds depends on several factors.



Saving for a Definite Future Goal

If you have a three-year-old child, you may face your first college tuition bill 15 years from now. Perhaps you know that in 22 years you will need a down payment for your retirement home. Because bonds have a defined maturity date, they can help you make sure the money is there when you need it.

Zero coupon bonds are sold at a steep discount from the face value amount that is returned at maturity. Interest is attributed to the bond during its lifetime. Rather than being paid out to the bondholder, it is factored into the difference between the purchase price and the face value at maturity.

You can invest in zero coupon bonds with maturity dates timed to your needs. To fund a four-year college education, you could invest in a laddered portfolio of four zeros, each maturing in one of the four consecutive years the payments will be due. The value of zero coupon bonds is more sensitive to changes in interest rates however, so there is some risk if you need to sell them before their maturity date. It is also best to buy taxable (as opposed to municipal) zeros in a tax-deferred retirement or college savings account because the interest that accumulates on the bond is taxable each year even though you do not receive it until maturity.

A bullet strategy can also help you invest for a defined future date. If you are 50 years old and you want to save toward a retirement age of 65, in a bullet strategy you would buy a 15-year bond now, a 10 year bond five years from now, and a five-year bond 10 years from now. Staggering the investments this way may help you benefit from different interest rate cycles.

Reasons You Might Sell a Bond Before Maturity

Investors following a buy-and-hold strategy can encounter circumstances that might compel them to sell a bond prior to maturity for the following reasons:

1. They need the principal. While buy-and-hold is generally best used as a longerterm strategy, life does not always work out as planned. When you sell a bond before maturity, you may get more or less than you paid for it. If interest rates have risen since the bond was purchased, its value will have declined. If rates have declined, the bond's value will have increased.
2. They want to realize a capital gain. If rates have declined and a bond has appreciated in value, the investor may decide that it's better to sell before maturity and take the gain rather than continue to collect the interest. This decision should be made carefully, as the proceeds of the transaction may have to be reinvested at lower interest rates.
3. They need to realize a loss for tax purposes. Selling an investment at a loss can be a strategy for offsetting the tax impact of investment gains. Bond swapping can help achieve a tax goal without changing the basic profile of your portfolio.



4. They have achieved their return objective. Some investors invest in bonds with the objective of total return, or income plus capital appreciation or growth. Achieving capital appreciation requires an investor to sell an investment for more than its purchase price when the market presents the opportunity.

Total Return

Using bonds to invest for total return, or a combination of capital appreciation (growth) and income, requires a more active trading strategy and a view on the direction of the economy and interest rates. Total return investors want to buy a bond when its price is low and sell it when the price has risen, rather than holding the bond to maturity.

Bond prices fall when interest rates are rising, usually as the economy accelerates. They typically rise when interest rates fall, usually when the Federal Reserve is trying to stimulate economic growth after a recession. Within different sectors of the bond market, differences in supply and demand can create short-term trading opportunities. For some ideas, read the content articles under “Profiting from Market Signals” and “Which Trade?” –in Learn More-Strategies Section.

Various futures, options and derivatives can also be used to implement different market views or to hedge the risk in different bond investments. Investors should take care to understand the cost and risks of these strategies before committing funds.

Some bond funds have total return as their investment objective, offering investors the opportunity to benefit from bond market movements while leaving the day-to-day investment decisions to professional portfolio managers.

Total Return Strategies Using Callable Securities

Many investors use callable securities within a total return strategy—with a focus on capital gains as well as income—as opposed to a buy and hold strategy focused on income and preservation of principal.

Owners of callable securities are expressing the implicit view that yields will remain relatively stable, enabling the investor to capture the yield spread over noncallable securities of similar duration. They must also have views on the likely range of rates over the investment period and the market’s perception of future rate uncertainty at the horizon date for reasons explained in risks of investing in callable securities. If an investor has the view that rates may well be volatile in either direction over the near term but are likely to remain in a definable range over the next year, an investment in callable securities can significantly enhance returns.

Premium callables may be used when the bullish investor believes that rates are unlikely to fall very far. Discount callables are a better choice when the investor believes volatility will be low but prefers more protection in an environment of rising interest rates.



Tax Advantaged Investing

If you are in a high tax bracket, you may want to reduce your taxable interest income to keep more of what you earn. The interest on U.S. government securities is taxable at the federal level, but exempt at the state and local level, making these investments attractive to people who live in high tax states. Municipal securities offer interest that is exempt from federal income tax, and, in some cases, state and local tax as well. Because of variables in supply and demand, tax-exempt yields in the municipal market can sometimes be quite attractive when compared to their taxable equivalents.

Ladders, barbells and bullets can all be implemented with municipal securities for a taxadvantaged approach best achieved outside of a qualified, tax-deferred retirement or college savings account. Buying municipals in a tax-deferred account is like wearing a belt and suspenders.

Bond swapping is another way to achieve a tax-related goal for investors who are holding a bond that has declined in value since purchase but have taxable capital gains from other investments. The investor sells the original bond at a loss, which can be used to offset the taxable capital gain or up to \$3,000 in ordinary income. He or she then purchases another bond with maturity, price and coupon similar to the one sold, thus reestablishing the position. To comply with the IRS "wash sale" rule, which does not recognize a tax loss generated from the sale and repurchase within 30 days of the same or substantially identical security, investors should choose a bond from a different issuer.

Diversifying Risk by Investing in Bond Funds

Investors who want to achieve automatic diversification of their bond investments for less than it would cost to construct a portfolio of individual bonds can consider investing in bond mutual funds, unit investment trusts or exchange-traded funds. These vehicles each have specific investment objectives and characteristics to match individual needs.

Swapping for Other Objectives

A tax loss is not the only reason to swap a bond. Investors can also swap to improve credit quality, increase yield or improve call protection. Remember to factor the sell and buy transaction costs into your estimations of return..



Where to Hold Your Bond Investments: Taxable or Tax-Deferred Accounts?

In a taxable investment account, your capital gains and investment income are subject to taxation in the year they are earned. In a qualified tax-deferred account such as an IRA or some college savings account, income and capital gains are not taxed until you start taking withdrawals, presumably at a future date.

Bonds and bond funds can be held in either type of account, but some investors will have a reason to choose one account type over the other. Municipal investments, for example, are best held in a taxable account, where they can serve to reduce the taxable returns. Taxable zero coupon bonds are best held in a tax-deferred account because their annual interest credits are taxable when earned, even though the investor does not actually receive them until the bond matures.

Since the maximum tax on capital gains was reduced to 15% in 2003, total return investors in a high income tax bracket may find advantages to holding their bonds in a taxable account. Others may prefer to invest for maximum income in their tax deferred accounts. The best solution depends on your individual circumstances and tax situation. Your tax or investment advisor can help you analyze the alternatives and reach the best solution.