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Financial Briefs

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Active vs. Passive Bond Investing

A great many investors are aware of only one way to manage their bonds: buy and hold them until they mature, reinvesting the redeemed funds in more bonds to hold until *they* mature. Not surprisingly, this is called a buy-and-hold strategy, and it's considered a form of passive management.

But there is another way to approach a bond portfolio. It's called active management and routinely involves selling bonds before they mature. Before considering active management, however, it's important to understand some bond fundamentals.

Bond Income vs. Capital Gains

Everybody knows that bonds generate income in the form of interest payments. But many people don't realize that bonds can also generate capital gains in the secondary market — the market where investors buy and sell existing bonds.

Interest rates are the result of prices that investors are willing to pay to receive the fixed-income streams from existing bonds. Whenever potential buyers of existing bonds decide that the bonds' annual income isn't enough relative to its price, they'll bid bond prices lower. As a result, the bonds' current yield, their effective interest rate, will rise. The result is that at any given time, the market value of a certain bond could be higher or lower than its face value, its original price, or its previous transaction price.

Individual bond prices can also change as a result of changes in their credit ratings. If a major bond agency reduces the rating of a bond, its price will normally go down; if the rating goes higher, the price will ordinarily go up. In either case, the price is bound to be different from

Continued on page 2

4 Reasons to Invest in Bonds

Bonds have a reputation as safe, stable investments. But writing off bonds as boring investments that are best for the risk-averse could be a mistake.

While it's true that investing in bonds tends to lack the dramatic highs (and lows) that come with investing in stocks, that doesn't mean you should ignore the opportunities bonds present. Here are four reasons you might want to have a portion of your portfolio in bonds.

1. Bonds are a way to diversify your portfolio.

Many financial experts recommend diversifying your portfolio to include a variety of asset classes, including bonds. This is a concept known as asset class diversification. Because various asset classes tend to perform differently at alternate times, you may be able to create a portfolio that generates more stable returns by investing across asset classes. For example, stocks and bonds tend to historically move in opposite directions, which means that owning some of both can help smooth out the ups and downs in your portfolio.

2. Bonds are (usually) less risky than equities.

If you are looking to decrease risk in your investment portfolio (such as when you near retirement), increasing your allocation to bonds may be one way to do that. However, keep in mind that less risky doesn't mean risk free. Bond issuers can default, plus you face what's known as inflation risk. Because bond payments are set in advance (that's why they're known as fixed-income investments), you may lose purchasing power due to inflation.

3. Bonds can provide a steady, predictable source of income.

Stocks and other investments are unpredictable — you don't know with any certainty how well a stock might perform in any given

Continued on page 3

FR2016-0308-0004

Active vs. Passive

Continued from page 1

its price when you bought it.

Selling to Capture Premiums or Higher Yield

Bonds whose prices are higher than their face value — something that often happens when interest rates have been falling for some time — are called premium bonds. If you're holding a premium bond to maturity, one thing is certain: no matter what happens to interest rates in the future, you're never going to benefit from this temporary increase in your bond's market value — unless you sell it. So in the right circumstances, it can make sense to sell a premium bond.

In certain circumstances, it can make sense to sell a bond that's fallen to a lower price than its purchase price. Why? First, selling a bond at a loss generates a potential tax advantage — a capital loss that come tax time, can be used to offset capital gains taken elsewhere. Second, in a market in which bond prices are falling, bond interest rates are rising. So investors can increase their net income if they sell a lower-yielding bond to purchase a higher-yielding bond.

Using the Yield Curve

Professionals know that the bond markets are more inefficient than the stock markets. One of the results is that anomalies frequently occur in what's known as the yield curve, the line on a graph that shows yield by maturity dates.

In theory, there is a gradual and proportional relationship between time to maturity and yield. On a normal yield curve, the line rises a bit steeply from left to right over the first few years and then begins to flatten out, with yields continuing to rise as the maturity gets longer.

In practice, however, abnormal relationships can emerge in which the yield for a slightly shorter maturity is higher than the yield for a certain longer maturity (an inverted yield curve). In this case, a premium may have developed for the longer maturity that could disappear once the market becomes fully aware of it. In such cases, active managers may decide to sell the longer maturity and buy the shorter one to book that capital gain.

Have some of your bonds become premium bonds, and could you benefit from selling them? Or have the prices of some of your bonds sunk below what you paid for them? Are there bonds on the market that could increase your income? Please call if you'd like to review your bond portfolio.

Dealing with Bond Price Fluctuations

There are two primary factors that affect bond prices — interest rate changes and credit rating changes. Interest rate changes typically will cause a bond's value to fluctuate more than credit rating changes.

As interest rates rise, a bond's price adjusts down, while the bond's price will increase when rates decrease. Simply put, bond prices and interest rates move in opposite directions. Also, bonds with longer maturity dates are more vulnerable to interest rate changes, since the difference will impact the bond for a longer time period. 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.

Credit ratings also influence a bond's price. 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. 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 tends to decline when a rating is downgraded and increase when a rating is upgraded. The price change brings the bond's yield in line with other bonds with similar ratings. However, these price changes are typically minor if the rating changes by only one notch. Certain downgrades are more significant, such as a downgrade that moves a bond from an investment-grade to a speculative rating, a downgrade of more than one notch, and a series of downgrades over a short period of time. In those situations, you should review whether you want to continue to hold the bond.

If you want to minimize the risk of price fluctuations, consider these tips:

- If you hold a bond to maturity, you receive the full principal value, so you won't be affected by any price fluctuations. Thus, consider purchasing bonds with maturity dates that match when you will need your principal.
- Consider investing in bonds with shorter-term maturities, which are less susceptible to interest rate changes.
- Design your bond portfolio using a ladder so you'll have bonds coming due every year or so. This strategy typically lessens the effects of interest rate changes. Since the bonds are held to maturity, changing interest rates won't result in a gain or loss from a sale. The bonds are maturing every year or two, so your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal coming due every year or so to reinvest at higher rates. In a declining interest rate environment, you have some funds in longer-term bonds with higher interest rates. A bond ladder keeps your bond portfolio invested in a range of maturity dates, evening out your interest income over time.
- Choose bonds that match your risk tolerance. Safer bonds, such as U.S. Treasury bonds or investment-grade corporate bonds, are less susceptible to credit rating risks.

4 Reasons

Continued from page 1

year or even how well certain types of stocks (like small-cap stocks or international stocks) will do. Bonds are a bit different. They are debt investments, which means you are essentially agreeing to loan an entity, like the government or a corporation, money for a certain period of time. That entity agrees to pay you a certain amount of interest (known as the coupon) over the time they have your money, plus repay your initial investment when the bond reaches maturity. That means unlike some other investments, you have a pretty good idea of how much money you're going to see from your bond investments over the years.

Of course, bonds aren't risk free. Bond issuers can default, and you could experience a loss. That's why riskier bond issuers tend to offer investors higher coupon rates — their greater risk is compensated by greater total return. But in general, bonds are more predictable in how much money they generate for investors than stocks, which is one reason they're so appealing to retirees.

4. Bonds can provide valuable tax savings.

Depending on the types of bonds you own, you may be able to save on taxes. While you'll pay normal taxes on corporate bonds, income from Treasury bonds (which are issued by the U.S. federal government) is free of state and local taxes. Then there are municipal bonds, or bonds issued by state and local governments. You won't pay federal tax on money earned on these investments and may also be exempt from state and local taxes. For anyone who is looking to minimize their tax burden, especially retirees, this can be an appealing proposition.

Questions about making bonds part of your investment strategy? Please call to discuss this topic in more detail.

Bonds and Your Portfolio

When selecting investments for your portfolio, you should custom fit your investments to your personal situation and specific financial goals.

By taking the time to consider certain specifics about bond investing, you can determine the best way to include bonds in your portfolio, which will help you pursue your short- and long-term financial objectives.

Identify Your Investment Goals

Your investment goals will help determine the role of bonds in your portfolio. An investor focused on long-term growth and capital appreciation with no need for current income will have a minimal need for bonds.

On the other hand, an investor looking for a balance of income and capital appreciation will have more bonds in his/her portfolio. An investor primarily interested in interest income will have a significant portion of his/her portfolio devoted to bonds.

Know Your Investment Time Frame

As you select bonds for your portfolio, it's important to consider when you will need the principal. Investors often purchase bonds with lengthy maturity dates because the yield on bonds tends to increase as maturity dates lengthen. While it may seem to make sense to purchase a bond with the highest return, realize that the price you obtain for a bond sold prior to maturity will be greatly affected by interest-rate changes.

By choosing bonds with maturity dates that closely line up with when you need your principal, you can limit the effects interest-rate changes will have on your portfolio.

Determine Your Risk Tolerance

Can you handle the higher risk that comes with a high-yield bond? If not, it may make more sense to select a lower-risk bond, such as U.S. Treasury securities.

U.S. Treasury securities are considered some of the safest bonds, so their interest rates tend to be lower than corporate and municipal bonds. Take time to consider your tolerance for risk before purchasing bonds.

Understand the Tax Ramifications

Different bonds are taxed differently. For example, interest income from U.S. Treasury securities is exempt from state and local taxes, but is subject to federal income taxes.

However, interest income from municipal bonds is exempt from federal income taxes and is typically exempt from state and local income taxes for residents in the issuing state.

With corporate bonds, interest income is subject to federal and state income taxes. Investors in higher tax brackets typically find tax exemption of interest income more valuable.

Any exemption from income taxes applies only to interest income, so capital gains from the sale of a bond are still subject to income taxes.

Consider Specific Bond Variables

Before you purchase a specific bond, make sure you fully understand its features, including the following:

- Maturity date of the bond
- Credit rating of the bond
- Call provisions
- Coupon rate
- Yield to maturity
- The bond's price
- Tax ramifications of interest income

The role of bonds in your portfolio will depend on these variables. Please call if you would like help evaluating bonds for your portfolio.

Business Data

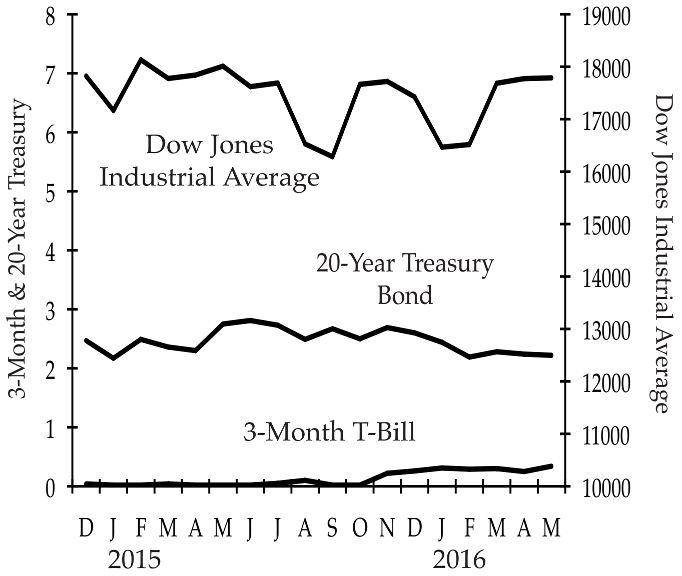
	Month-end				
Indicator	**Mar-16**	**Apr-16**	**May-16**	**Dec-15**	**May-15**
Prime rate	3.50	3.50	3.50	3.50	3.25
3-month T-bill yield	0.30	0.25	0.34	0.26	0.02
10-year T-note yield	1.91	1.84	1.82	2.24	2.23
20-year T-bond yield	2.28	2.24	2.22	2.60	2.75
Dow Jones Corp.	3.04	2.80	2.89	3.43	2.98
GDP (adj. annual rate)#	+2.00	+1.40	+0.80	+1.40	+0.60

	Month-end			% Change	
Indicator	**Mar-16**	**Apr-16**	**May-16**	**YTD**	**12-Mon.**
Dow Jones Industrials	17685.09	17773.64	17787.20	2.1%	-1.2%
Standard & Poor's 500	2059.74	2065.30	2096.96	2.6%	-0.5%
Nasdaq Composite	4869.85	4775.36	4948.05	-1.2%	-2.4%
Gold	1237.00	1285.65	1212.10	14.1%	1.7%
Unemployment rate@	4.90	5.00	5.00	0.0%	-7.4%
Consumer price index@	237.10	238.10	239.30	0.8%	1.1%
Index of leading ind.@	123.10	123.10	123.90	0.0%	1.3%

\# — 3rd, 4th, 1st quarter @ — Feb, Mar, Apr Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

December 2014 to May 2016



News and Announcements

Why Do Interest Rates Fluctuate?

While it is difficult to predict how much and in which direction interest rates will move, the factors causing those fluctuations include:

- **Economic conditions** — The volume of business activity affects interest rates. In periods of economic growth, businesses require large amounts of debt to finance increases in working capital and fixed assets. This increase in demand coupled with increased consumer borrowing puts pressure on interest rates to rise. As the economy contracts, businesses and consumers cut back on their borrowing, and interest rates start to fall.
- **Monetary policy** — The Federal Reserve attempts to assist the economy in growing at a stable rate with low inflation. Their actions, including buying or selling Treasury securities in the open market, raising or lowering the discount rate, and changing reserve requirements, impact the level of interest rates.
- **Expected inflation** — The market interest rate on a risk-free security has two components — the real rate of return plus an inflation premium. Investors' expectations about the future rate of inflation impact the level of interest rates.
- **Federal deficit** — Since the federal government is such a large borrower in our economy, significant changes in the amount being borrowed can impact overall interest rates.

Other factors can also impact interest rates, such as the rate of saving by individuals and corporations, international capital flows, and the premium required by investors to assume interest rate risk. Even though the factors affecting overall interest rates are known, the interplay of all of these factors makes it difficult to precisely predict the future direction of interest rates.

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