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Financial Briefs

JULY/AUGUST 2019

Bond Investing Strategies

Bonds are an important part of a well-balanced portfolio. You should consider what bonds have to offer as well as strategies to build your portfolio.

Bonds Deliver Income

If you are looking for a reliable source of income, you should include bonds in your portfolio. Even when interest rates are low, there are a variety of bonds that provide higher returns, such as high-yield bonds and emerging market debt.

Bonds Offer Diversification

If you put all of your money into one asset class, such as stocks, your entire portfolio is at greater risk. By investing a portion of your portfolio in bonds, you will reduce your risk. Bonds can help you preserve capital when the stock market is experiencing volatility.

Bonds Preserve Principal

When you are getting closer to the time you will need cash from your investments, such as within five years of retirement, you should move more money to fixed-income investments. The stock market can experience huge losses over a short period of time, but your fixed-income investments are less likely to experience large losses over the short term. Many investors increase their allocation to bonds as they move closer to their goals to preserve their principal.

Bonds Offer Tax Advantages

If you are trying to reduce your tax liability, certain types of bonds can help you meet this challenge. For example, the interest earned on municipal bonds is free from federal taxes, and if you own a bond issued within the state you live in, it will

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Managing Bond Risks

All investments are subject to risk, although the types of risk can vary. While you can't totally eliminate risks, you can minimize them. For bonds, consider these strategies:

Interest rate risk — Interest rates and bond prices move in opposite directions. A bond's price will increase when interest rates fall and decrease when interest rates rise. This occurs because the existing bond's price must change to provide the same return as an equivalent, newly issued bond paying prevailing interest rates. The longer the bond's maturity, the greater the impact of interest rate changes. Also, the effects of interest rate changes tend to be less significant for bonds with higher-coupon interest rates.

To reduce this risk, consider holding the bond to maturity. This eliminates the impact of interest rate changes, since the total principal value will be paid at maturity. Thus, selecting a maturity date that coincides with your cash needs will help reduce interest rate risk. However, you may still receive an interest income stream that is lower than current rates. Selecting shorter maturities or using a bond ladder can also help with this risk.

Reinvestment risk — You typically know what interest income you will receive from a bond, but you must then take the periodic income and reinvest it, usually at varying interest rates. Your principal may also mature at a time when interest rates are low.

Staggering maturities over a period of time (laddering) can lessen reinvestment risk. Since the bonds in your ladder mature every year or so, you reinvest principal over a period of time instead of in one lump sum. You may also want to consider zero-coupon bonds, which sell at a deep discount from par value. The bond's interest rate is locked in at purchase, but no interest is paid until maturity. Thus, you don't have to deal with reinvestment risk for interest payments, since you don't receive the interest until your

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Bond Investing

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also be state income tax free. While taxes shouldn't be the only reason to invest in bonds, consider this as part of your overall financial plan.

Building a Bond Portfolio

Based on your goals and risk tolerance, there are many strategies for building your bond portfolio. Investors who are looking for income but don't want to be actively involved in portfolio management may want to employ a buy-and-hold approach. Investors who want more involvement, along with security and predictability, may want to look at index matching and immunization strategies. For investors who want to actively manage portfolios, search for higher returns in exchange for higher risk.

Consider the following bond strategies to determine what strategy would be most comfortable for you. The four primary strategies are:

- Passive or buy and hold
- Index matching or quasi-passive
- Immunization or quasi-active
- Dedicated and active

1. Passive Bond Strategy

With a passive bond strategy known as buy and hold, you are buying individual bonds and holding them until maturity. The bond's coupon rate is the amount of interest income earned each year based on the face value of the bond, and its yield is the estimated rate of return, assuming it is held until its maturity date. The cash generated by bonds can be used for income needs or can be reinvested into other bonds or even other asset classes.

Unlike more active strategies, the buy and hold investor does not actively deal with the future direction of interest rates, nor is he/she focused on the current value of the bonds due to changes in the yield. The assumption is that the bond's full par value will be received upon maturity.

Because of the investor's minimal involvement, passive bond portfolios provide stability during market volatility. The primary reason for this is that the strategy invests in very high-quality, noncallable bonds, such as government or investment-grade corporate or municipal bonds.

Bond laddering is probably the most common form of passive bond investing and provides a steady income stream. The idea of a bond ladder is simple: instead of investing in bonds that mature at roughly the same period of time, or in a haphazard pattern of maturities, you spread your portfolio out in roughly equal amounts over maturities that are evenly separated from one another. Ideally, all of these bonds are from the same issuer or from issuers with the same credit quality. When a bond matures, the principal is reinvested at the bond ladder's longest maturity date.

If interest rates are higher then, your annual bond income will go up; if rates go down across the board, your income will still benefit from the relatively higher rates on the rest of your portfolio. In either case, because most of your portfolio is still throwing off the same cash flow, your annual income won't change much, which makes your income more predictable than if all of your bonds matured in any single year.

2. Indexing Bond Strategy

An indexing bond strategy is what is known as a quasi-passive strategy. The primary objective is to provide similar return and risk characteristics of a particular index. It is similar to tracking a specific stock market index, as a bond portfolio can be structured to copy a published bond index. Probably one of the most well-known and widely used bond indexes is the Barclays Capital U.S. Aggregate Bond Index. Using this works best with a large bond portfolio due to the number of bonds that need to be purchased to replicate it.

While this strategy is comparable to a buy-and-hold strategy, it does offer some flexibility, as the portfolio can be rebalanced to reflect changes in the index.

If you invest using an indexing strategy, you need to be aware that there are transaction costs associated with the original investment as well as when the portfolio is periodically rebalanced.

3. Immunization Bond Strategy

With characteristics of both active and passive, the immunization bond strategy invests a portfolio for a defined return for a specific period of time regardless of potential influences, such as changes in interest rates. The immunization strategy is for the investor who is willing to give up potential gains for the assurance that the portfolio will achieve its desired returns.

This strategy is often used in institutional investing, when companies need to ensure they have a certain amount of cash flow to meet their liabilities at a certain period of time, but it is also an effective strategy that individuals can use.

The immunization strategy is best used with high-grade bonds that have a remote possibility of default or with zero-coupon bonds. Zero-coupon bonds match the maturity of the bond to the date the funds are needed.

4. Active Bond Strategy

An active bond strategy is about maximizing total returns. Investments are actively managed based on the anticipation of interest rate changes, credit changes, and valuation changes. The premise of active strategies is investors are making investments based on what the future will bring.

For example, the active strategy investor would buy bonds with longer maturity durations in anticipation of lower long-term interest rates, buy junk bonds in anticipation of economic growth, or buy Treasuries when the Federal Reserve is expected to increase the money supply.

Please call if you'd like to discuss the role of bonds in your investment portfolio.

Managing Bond Risks

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principal matures.

Inflation risk — Since bonds typically pay a fixed amount of interest and principal, the purchasing power of those payments decreases due to inflation, which is a major risk for intermediate- and long-term bonds.

Investing in short-term bonds reduces inflation's impact, since you are frequently reinvesting at prevailing interest rates. You can also consider inflation-indexed securities issued by the U.S. government, which pay a real rate of return above inflation.

Default and credit risk — Default risk is the possibility the issuer will not be able to pay the interest and/or principal. Credit risk is the risk the issuer's credit rating will be downgraded, which would probably decrease the bond's value.

To minimize this risk, consider purchasing U.S. government bonds or bonds with investment-grade ratings. Continue to monitor the credit ratings of any bonds purchased.

Call risk — Call provisions allow bond issuers to replace high-coupon bonds with lower-coupon bonds when interest rates decrease. Since call provisions are generally only exercised when interest rates decrease, you are forced to reinvest principal at lower interest rates.

U.S. government securities do not have call provisions, while most corporate and municipal bonds do. Review the call provisions before purchase to select those most favorable to you.

Keep in mind the assumption of risk is generally rewarded with higher return potential. One of the safest bond strategies is to only purchase three-month Treasury bills, but this typically results in the lowest return. To increase your return, decide which risks you are comfortable assuming and implement a corresponding bond strategy. Please call if you'd like help with your bond investing strategy.

How Inflation Affects Bonds

While a little inflation is healthy for the economy, inflation has a direct impact on all of us in some way. For investors, the degree of impact varies, depending on their asset allocation. For example, the effects of inflation on stocks are often deemed negligible, since stock prices often rise in correlation with the price of goods and services. Inflation's effects on bonds, on the other hand, are more tangible.

When you purchase bonds, you're essentially lending money to either the government or a corporation with a promissory note in the form of a stipulated interest rate (coupon) and the maturity date when your principal will be returned. Because any given bond transaction occurs in today's dollars, there's always the likelihood that the principal you lend through purchasing bonds simply won't hold the same purchasing power by the bond's maturity date, particularly since many bonds have a 5-10 year life span, therefore increasing the probability of inflation. The relationship between inflation and bonds is an inverted one: the higher inflation rises, the less valuable bonds become.

When we consider a bond's cash flow from purchase to maturity, the effects of inflation become a bit more complicated, particularly because over the course of a bond's lifetime, its coupon and the current interest rates don't always align. While this can certainly work to your favor when interest rates are low, it can be problematic during times of inflation, when the Fed typically raises the interest rates in an attempt to slow inflation's pace. Remember: most bonds are similar to stocks in the sense that they're traded on the market. Even the slightest rise in interest rates affects their market price because they must now be traded at a discount lower than their face value. Therefore, in spite of the par value you've paid for a bond, it might sell for less or more than that value, depending on market interest rates. Bonds with a coupon lower than the current interest rate must sell at a discount to offset the interest rate hike.

If you own individual bonds, assuming you hold them to maturity, their par value is generally secure, excepet for the call or default risk. Likewise, your bond's interest payments will continue at the originally promised rate. Sell prior to maturity, however, and you'll incur the loss in face value. For this reason, many individual bondholders avoid selling; though, depending on inflation and interest rates at the time of your bond's maturity date, selling currently held bonds and purchasing new investments could provide better return in the long run.

Much of the impact of inflation on your individual bonds, too, depends on the term and even type of bond. Short-term bonds hold less risk when it comes to inflation for a few key reasons: a) there's less chance of inflation within a shorter investment period; b) the rate at which inflation occurs is likely to be less; and c) there's a greater chance you'll hold the bond to maturity. This comes at a price, since short-term bond coupons are typically much less attractive than those of long-term bonds. Your bonds' exposure to inflation also depends on the category of bonds you invest in. TIPS bonds, for example, are designed to rise in value with inflation.

Any fluctuation in the economy, regardless of the direction, can affect bonds and stocks alike, albeit in different ways. The inherent risk even in an investment praised for its stability only serves to highlight the importance of portfolio diversification. To discuss the relationship between your investment plans and changing interest rates, please call.

Business Data

	Month-end				
Indicator	**Apr-19**	**May-19**	**Jun-19**	**Dec-18**	**Jun-18**
Prime rate	5.50	5.50	5.50	5.50	5.00
3-month T-bill yield	2.39	2.31	2.09	2.47	1.90
10-year T-note yield	2.55	2.14	2.05	2.89	2.91
20-year T-bond yield	2.78	2.39	2.34	3.03	2.97
Dow Jones Corp.	3.74	3.63	3.22	4.40	3.94
GDP (adj. annual rate)#	+3.40	+2.20	+3.10	+2.20	+2.20

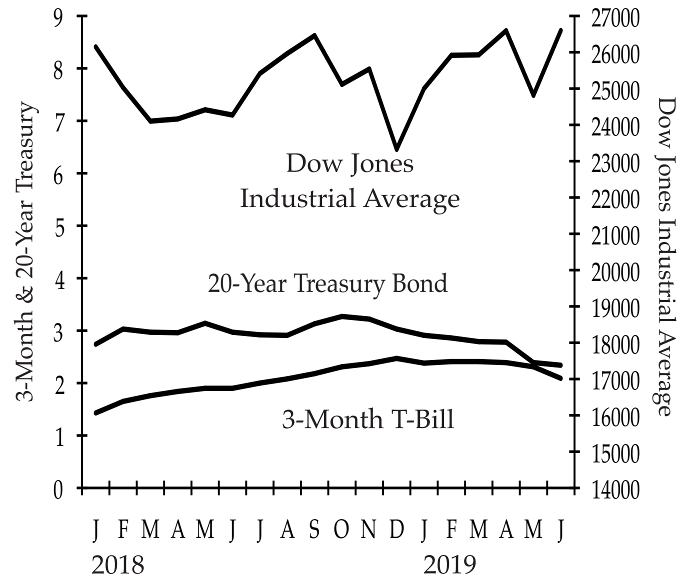
	Month-end			% Change	
Indicator	**Apr-19**	**May-19**	**Jun-19**	**YTD**	**12-Mon.**
Dow Jones Industrials	26592.91	24815.04	26599.96	14.0%	9.6%
Standard & Poor's 500	2945.83	2752.06	2941.76	17.3%	8.2%
Nasdaq Composite	8095.39	7453.15	8006.24	20.7%	6.6%
Gold	1282.30	1295.55	1409.00	9.9%	12.7%
Unemployment rate@	3.80	3.60	3.60	-2.7%	-5.3%
Consumer price index@	254.20	255.55	256.09	1.6%	1.8%

— 3rd, 4th, 1st quarter @ — Mar, Apr, May 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

January 2018 to June 2019



News and Announcements

Bond Investing Tips

Consider the following bond investing tips:

- **Determine your objectives before investing.** Decide how much to invest in bonds.
- **Diversify your bond holdings among different bond types.** Consider government, corporate, and municipal bonds, as well as different industries, credit ratings, and maturities.
- **Understand the risks that affect bonds.** The most significant risk is interest rate risk. When interest rates increase, bond values fall, while values rise when interest rates decline. Other risks include default risk and inflation risk.
- **Choose bond maturity dates carefully.** When you need your principal is a major factor, but the current interest rate environment may also affect your decision. Rather than investing in one maturity, you may want to stagger or ladder the maturity dates.
- **Follow interest rate trends.** At a minimum, follow the prime rate, Treasury bill rates, and Treasury bond rates. Understand the significance of the yield curve and track its pattern over time.
- **Compare interest rates for specific bonds before investing.** Interest rates can vary substantially among different bond types and among bonds with different maturities or credit ratings.
- **Research a bond before purchase.** Review the credit quality, coupon rate, call provisions, and other significant factors.
- **Consider the tax aspects.** By comparing the after-tax rate of return for various types of bonds, you may be able to increase your return.
- **Review your bond holdings periodically.** Evaluate the credit ratings of all your bonds at least annually to ensure the quality hasn't deteriorated. Also, ensure your holdings are still consistent with your overall investment objectives.

FR2019-0321-0038