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Bond Basics

Benefits of investing in bonds: Potential for growth, historically lower risk, diversification and income are some of the benefits of investing in bonds. Generally, bonds have provided investors with growth and historically demonstrated less volatility than stocks. Because economic events that decrease stock prices tend to increase bond prices, and vice versa, adding bonds to a portfolio can provide diversification benefits. Bond investors generally receive income at fixed intervals that can be used to offset cash obligations or increase portfolio liquidity.

Bonds and interest rates: There exists an inverse relationship between bond prices and yields. If interest rates fall, bond prices rise and vice versa. Suppose an investor purchases a 20-year $1,000 bond with a yield of 8% and interest payable annually. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for the original price of $1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower interest or coupon payments (10% – 8% = 2% less per year in interest payments).

Diversification does not ensure a profit or protect against a loss in a declining market. Bonds are subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

2012 FIVE STAR PROFESSIONAL Wealth Manager

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Are Bonds Adding to Your Equity Exposure?

- As the article outlines, high-yield bonds and bank loans, also known as floating rate debt, will generally perform well during periods of economic growth.
- However, during recessionary periods or times of turmoil, U.S. Treasuries will outperform as part of a "flight to quality."

These are trying times for yield-seekers. The Federal Reserve has kept interest rates ultralow for more than two years, and Federal Reserve chairman Ben Bernanke gave no indication in his recent press conference that the Fed will depart from that stance anytime soon. That may be good news for those in the market for home loans, but it's surely unwelcome for seniors and others trying to wring a livable income stream from their portfolios. Yields on cash instruments such as certificates of deposit are barely in the black, while you're lucky to pick up a yield of more than 3% on an intermediate-term bond fund.

Given this backdrop, it probably shouldn't be surprising that some investors appear to be chasing yields. Among bond funds, some of the biggest beneficiaries of new assets during the past year have been those that offer higher yields than high-quality bonds in exchange for some extra risk.

Of course, it's highly possible that investors are making the not unreasonable bet that the economy will continue to improve, thereby boosting these credit-sensitive sectors of the bond market. (Issuers are less likely to default on their bonds in a strengthening economic environment.) But it's also likely that some investors are focusing on the potential for higher yields without paying due attention to the downside.

All market shocks are different, of course, but they're often characterized by a flight to quality that puts pressure on credit-sensitive securities such as high-yield bonds and bank loans. During the period from mid-2007 through December 2008, for example, both high-yield bond funds and bank-loan funds performed poorly. This precipitated an unprecedented buying opportunity in credit-sensitive bonds, but following a more than two-year run-up in such securities, valuations aren't what they once were.

In addition to considering the risks, investors who are venturing into credit-sensitive bonds at this juncture should also be aware of what they might not be getting: diversification, particularly if they're looking to bonds as an antidote to an equity-heavy portfolio. It's true that credit-sensitive sectors like high yield and bank loans can be considered a good diversifier for portfolios that are skewed toward high-quality fixed-income securities such as government bonds, mortgage-backed securities, and high-quality corporate debt.

The high-yield sector's performance correlation with the equity market has been strong during the past decade (this means that, whether rising or falling, they tend to move together). The correlation of bank-loan funds with stocks has also been relatively strong (although less so than that of high-yield bond funds). Both asset classes have been more highly correlated with stocks than with bonds.

Does that mean you should reflexively avoid high-yield and bank-loan funds? Not necessarily. These bonds do provide some diversification benefit to high-quality bonds. And while high-yield bonds wouldn't be impervious in a period of rising interest rates, their extra yield cushions would most certainly hold them in better stead than gilt-edged Treasuries in such an environment. And bank-loan funds offer built-in protection against rising interest rates. If the economy continues to strengthen, high yield and bank loans would likely continue to chug along. But it's also a mistake to assume that a bond is a bond is a bond. If you're looking at mutual funds that delve into credit-sensitive sectors, it's crucial to thoroughly understand a prospective holding's strategy and downside potential before adding it to your portfolio.

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not ensure a profit or protect against a loss in a declining market.

Municipal Bonds and Tax-Equivalent Yields

- Municipal bonds are usually only appropriate for those in the highest income tax brackets. Those at lower income tax brackets are better off enjoying the higher yields offered by corporates or U.S. Treasuries and paying the income tax derived from these types of bonds.
- If you purchase a municipal bond by an issuer in your state, the interest income is tax-free at both the federal and state levels.

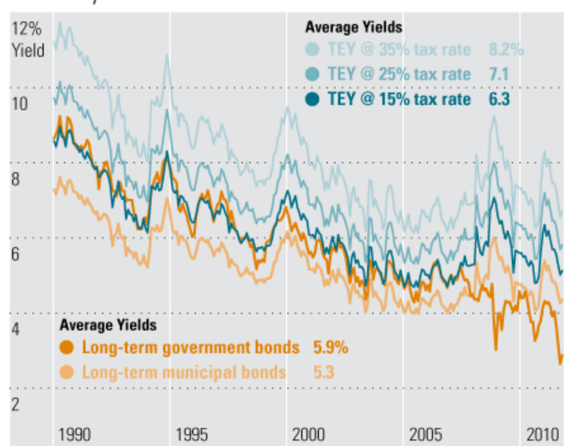
When building a portfolio, it is important for investors to take into account the ability of various investments to build wealth over time (their growth potential) as well as their potential to generate income. Bonds are debt instruments issued by governments, institutions, or corporations that pay interest periodically, making them a great choice for investors looking for current income. One downside to most types of bonds, however, is that the income they generate is subject to taxes. Municipal bonds are one exception.

Municipal bonds (munis) are issued by states, counties, cities, and other government entities and can be categorized into general obligation bonds or revenue bonds. General obligation bonds are backed by the "full faith and credit" of the issuer or its ability to bring in tax revenue. Revenue bonds are backed by income generated from specific projects or agencies. These bonds are often issued by hospitals and airports and are typically considered riskier than general obligation bonds.

Regardless of type, municipal bonds can offer an aftertax equivalent yield that is meaningfully above other bond investments. Yield is usually expressed as a percentage and can be described as the cash distributed periodically from an investment—similar to an interest rate. Municipal bond income is often protected from federal and state income taxes, making these investments desirable for investors in higher tax brackets, but capital gains taxes must be paid if the bonds are sold for more than their purchase price. One way to compare municipal bonds with taxable bonds is by calculating the tax-equivalent yield, which represents the before-tax yield an investor would need to achieve on a taxable bond in order to match a given municipal bond yield.

The image depicts yields for long-term government bonds, long-term municipal bonds, and municipal bond tax-equivalent yields for three different tax brackets. During the time period studied, average municipal bond yields have been below average long-term government bond yields—5.3% compared with 5.9%. However, average tax-equivalent yields have ranged between 6.3% and 8.2%—depending on the tax rate. The higher an investor's marginal tax rate, the greater their tax-equivalent yield will be and the more desirable municipal bonds are as an investment. For example, an investor in the 35% tax bracket not investing in municipal bonds would need an investment producing an 8.2% before-tax yield in order to match a municipal bond yield of 5.3%. An investor in the 15% tax bracket would only need an investment producing a 6.3% before-tax yield. Historically, tax-equivalent yields for all tax brackets analyzed have exceeded long-term government bond yields.

Municipal Bonds and Tax-Equivalent Yields
January 1990–October 2011



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Government bonds are guaranteed by the full faith and credit of the United States government as to timely payment of principal and interest, while municipal bonds are not guaranteed. State taxes have been ignored in estimating tax-equivalent yields. Municipal bonds may be subject to the alternative minimum tax (AMT) and state or local taxes, and federal taxes would apply to any capital gains distributions.

Source: Long-Term Government Bonds—20-year U.S. Government Bond; Municipal Bonds—Barclays Municipal Bond 20-year index; Federal tax rates from the Internal Revenue Service.

Tax-friendly States for Retirees

- Though taxes should not be the most important factor when deciding where to live in retirement, different tax levels between states can have a material impact on how long your retirement portfolio will last.

Federal taxes are the same wherever you choose to retire; however, state and local taxes add up depending on the state you pick to spend your retirement years. Taxes may apply to your retirement/pension income, purchases, real estate and social security benefits.

Taxes on individual and pension income differ from state to state. Seven states in the U.S. (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) currently do not tax individual income. On the other hand, California, District of Columbia, Hawaii, Iowa, Maine, New Jersey, New York, Oregon, and Vermont tax retirement income at a rate of 8% or higher. Pennsylvania and Mississippi exempt pension income completely, while states like Michigan and Maine exempt only a portion of pension income. If you estimate receiving considerable income in retirement, state income taxes could play a significant role in what you get to keep.

In addition to state taxes on retirement and pension income, retirees also need to look at sales tax charged on items they purchase. Sales tax varies from state to state with some states charging sales tax as high as 7%, while others adopt a “no sales tax” policy. Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales tax, while California has the highest sales tax rate of 8.25%. Retirees who rely only on a fixed source of income in retirement should also carefully consider property taxes and estate taxes when estimating their tax liabilities.

Source: 2011 CCH Whole Ball of Tax. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. The information provided is as of October 2011. Please consult with your financial professional regarding such services.

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