

Why Own Bonds?

The first in a series of presentations on fixed-income investing

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Investment portfolios often comprise a mix of equities, bonds, cash

- Virtually all investors hold a portion of their funds in cash to cover unexpected emergencies
- Investors relying on their investment portfolio to meet everyday living expenses may hold a combination of:
 - Cash
 - Bonds and CDs
 - Equities (dividend-paying and growth investments)

Why are we focusing on bonds?

High interest rates on bonds are attracting increased investor attention

- As bonds become more attractive investments, this may diminish flow of funds into equities

Recent headlines:

- **WSJ: It's a Good Time to Buy Bonds**, With high yields and stock prices, consider rebalancing your portfolio.
- **Bloomberg: Rising bond yields** could be starting to lure investors away from equities as stock-fund flows slow and bond inflows pick up.

What is a bond?

- A bond is like a loan
 - The investor lends money to the issuer of the bond
 - The issuer (the borrower) agrees to repay the loan at full face value at some future date, in addition to making periodic interest payments.
 - Typically, the bond may also be sold in the secondary market ahead of its maturity, for more or less than face value
- In contrast, stocks represent an ownership interest in a company
 - Stocks typically are riskier than bonds – their values fluctuate more than bonds, and stocks generally have higher rates of return, over time, than bonds

This presentation focuses on the role of bonds in portfolio allocation

- Future presentations may cover:
 - Individual bonds versus bond funds & ETFs
 - Building bond ladders
 - Duration and interest rate risk;
 - Credit risk
 - Various Treasury and agency debt instruments
 - Other income-producing assets (BDC's, Preferreds, CLOs)

Investors can choose from a variety of bonds

- Tax-free (municipals) and/or taxable securities
- MMFs or short, medium, or long-term bonds
- Individual bonds or bond funds
- International bonds
- Low-risk bonds with low yields and reduced-price volatility
 - Short-term investment grade government bonds and highly-rated company debt
 - Short-term CDs and I-bonds
- Higher-risk bonds with higher yields and increased price volatility
 - High yield (or junk) bonds from non-investment grade companies and higher-risk municipalities.
 - Longer-term bonds with higher yields (and greater interest rate risk)

What are the benefits of holding bonds?

- Bonds may reduce overall portfolio volatility
 - Bond values are less volatile than the stock market
 - Bonds can fund large purchases and help with unexpected expenditures,
 - Avoid the forced sale of stocks during a downturn
- Bonds can provide a steady, predictable source of income and return of capital over a fixed-term
- Interest rates on bonds/CDs exceed yields on savings and MMF accounts
- Potential tax advantages: Interest from munis is exempt from Federal tax; US Treasury securities are exempt from state and local taxes
- Diversification: Risk is spread across different asset types

There is no “one-size fits all” Portfolio or Investment Strategy

- What may work for me will likely not be suitable for others
- Strategies vary according to:
 - Personal finances
 - Annual expenses
 - Amount of guaranteed income (e.g., social security, pensions, annuities)
 - Risk tolerance
 - Time horizon
 - Portfolio objectives

Portfolio allocation strategies for retirees

- Common advice: 60% equity/40% bonds
- Many 401Ks offer target funds that increase bond allocations as retirement nears:
 - Vanguard **2040** Target Fund is 75% equity and 25% bonds
 - Vanguard **2025** Target Fund is 48% equity and 52% bonds
 - TSP offers **Lifecycle Funds** with similar equity/bond allocations
- An approach advocated by Morningstar is a dividing a portfolio into 3 buckets: cash, bonds, and equity

Bucket Approach to portfolio allocation

- Objective is to enable investor to withdraw spending money while letting stock portfolio grow in good times and recover from bad times.
- Tailor portfolio allocation to individual financial needs
- Assess shortfall between guaranteed income (e.g., social security, pension, annuities) and ***annual expenses***
- Then put aside sufficient cash to cover X months of any shortfalls between expenditures and guaranteed income; **(Bucket 1)**
- **Hold** low risk bonds or dividend paying investments to cover an additional X years of such shortfalls; **(Bucket 2)**
- Hold remainder in equities **(Bucket 3)**.

Example of bucket approach:

Annual expenses:	\$100,000
Guaranteed income:	65,000
GAP:	\$35,000

- Assume investment portfolio is \$1 million
- Portfolio needs to produce \$35,000 each year in cash flow
- Equivalent to a withdrawal rate of 3.5%

Bucket 1 – Cash

Bucket 1 equals two years' worth of withdrawals

- This is equivalent to \$70,000 in cash that might held be in:
 - Checking accounts
 - Bank and investment firm MMFs
 - Short-term CDs

Bucket 2 – High-quality bonds and CDs

- Assuming a \$35,000 annual withdrawal from the portfolio, another \$280,000 (\$35,000 times 8 years) would be in bucket 2.
- Front-end of portfolio is high-quality short-term instruments;
 - Short-term bank CDs
 - Short-term bonds
 - Short-term inflation-protected securities
- Remainder is in:
 - Intermediate-bonds and bond funds
 - High-quality dividend paying companies and funds

Bucket 3 – Equities

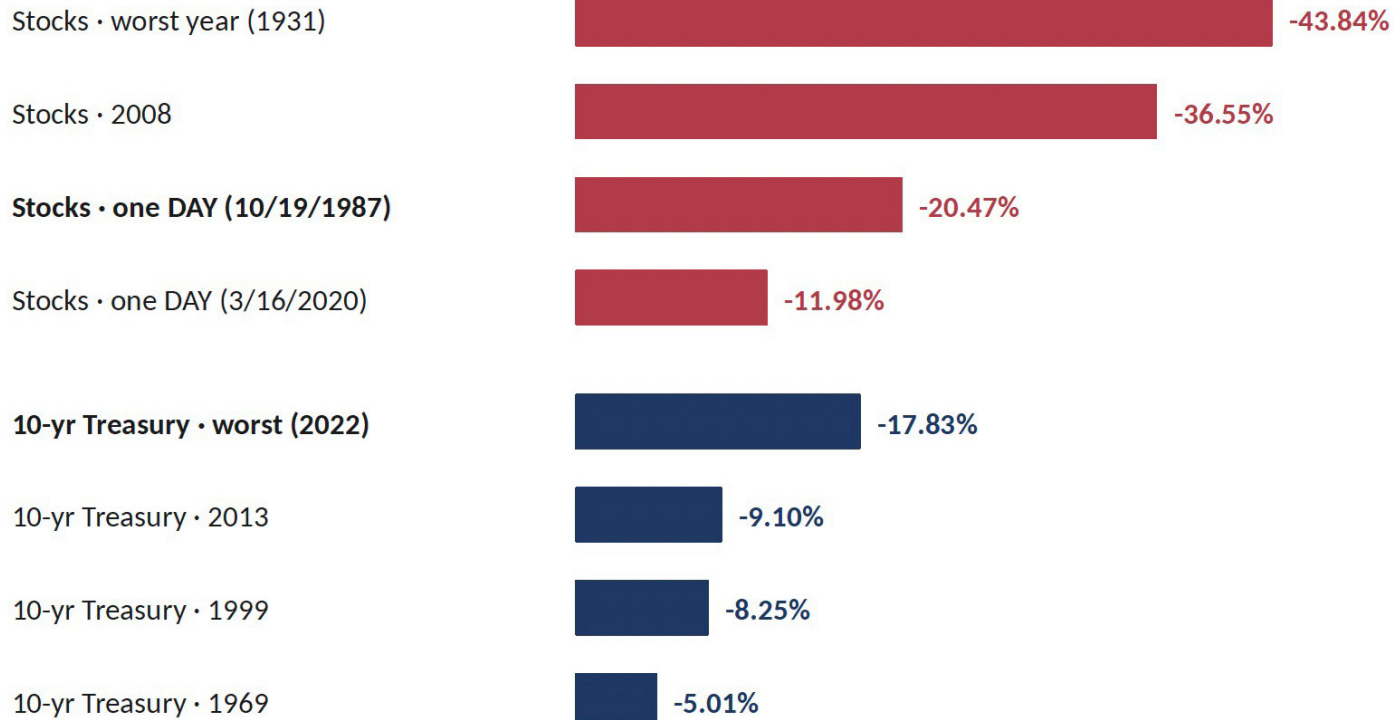
Remainder -- \$650,000 -- held in higher-risk, higher-yielding:

- Individual equities
- Equity ETFs and Funds

Overall portfolio (buckets 1, 2 and 3):
65% equity/ 28% bonds/ 7% cash

Final thoughts

- The optimal allocation of an investment portfolio across cash, bonds, and equity will vary according to individual factors
- Holding cash reserves and bonds limits the risk of forced sales of equities during stock market downturn
- Bonds are less risky than equity and generate dependable income but generally at lower returns than equity
- The equity/bond /cash allocation is a major determinant of a portfolio's long-term return



What the data shows

- The worst stock DAY (-20.47%) was larger than the worst Treasury YEAR (-17.83%).
- Most bad Treasury years were -5% to -9%.
- The rule of thumb holds up well.
- Bond funds with other durations differ.