In This Issue...

Diversifying Your Bond Portfolio
Incorporate Bonds into Your Portfolio
Consider a Bond Tent
How and Why to Build a Bond Ladder
Business Data
News and Announcements

PRO TAX
FINANCIAL SERVICES

761 S. Stapley Drive
Mesa, AZ 85204
Phone (480) 464-1040
Fax (480) 464-2306
Email protax@cox.net

Matthew T. Penkert, CFP®

Pro Tax is a Registered Investment Advisory firm with the Arizona Securities Division. Please contact Pro Tax Financial Services at (480) 464-1040 if you would like an updated copy of the Form ADV part II.

Financial Briefs

SUMMER 2017

Diversifying Your Bond Portfolio

Most investors understand the benefit of diversifying their stock portfolios: it's a matter of spreading your risk. But does the same principle apply to a bond portfolio? The simple answer is yes.

Bonds carry risk. As an asset class, bonds pose less risk than stocks for the simple reason that if and when an issuer goes out of business, bondholders take precedence over stockholders when it comes to distributing assets.

Here, we're talking about credit risk — just one of the several different kinds of risk bond investors face. It's impossible to eliminate this risk entirely from any bond portfolio: companies go out of business and pay bondholders pennies on the dollar, and governments — even sovereign national governments — can run into financial trouble and pay out later than scheduled or renegotiate their debt on terms that are less favorable to investors.

U.S. Treasuries' Safety Comes at a Cost

When it comes to credit risk, the outlier is U.S. Treasuries: Treasury bills, bonds, and notes. Backed by what is still regarded as the strongest, most stable government in the world, U.S. Treasury securities are considered the safest choice for receipt of timely interest payments and 100% redemption. So Treasuries remain bond investors' best choice for minimizing the chances that they won't receive redemptions at the bonds' face value.

But because Treasuries are the safest bonds out there, they come with a downside: across the maturity spectrum, the interest rates Treasury securities pay are among the lowest you'll find. In other words, you trade income for safety — and not having the income you need to meet your goals has to be considered a risk.

So why diversify away from Treasury bonds? Not to control risk better, but to achieve higher income. And that's the principal reason for diversifying your bond portfolio: to achieve a better balance between risk and reward to match your needs and objectives.

There are basically three dimensions of bond diversification: issuer, credit quality, and maturity.

Different Issuers, Different Risks and Rewards

There are five major sectors of the bond market, and they're defined by the class of issuer. Each poses a different risk/reward profile. As in all financial markets, the lower risk you want, the lower your potential rate of return; to get a

Continued on page 2

Incorporating Bonds into 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 appropriate 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 bonds should play in your portfolio. An investor focused on long-term growth and capital appreciation with no need for current income will have less 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, consider when you will need the principal. Investors often purchase bonds with long maturity

Continued on page 3

Copyright © Integrated Concepts 2017. Some articles in this newsletter were prepared by Integrated Concepts, a separate, nonaffiliated business entity. This newsletter intends to offer factual and up-to-date information on the subjects discussed, but should not be regarded as a complete analysis of these subjects. The appropriate professional advisers should be consulted before implementing any options presented. No party assumes liability for any loss or damage resulting from errors or omissions or reliance on or use of this material.

FR2017-0217-0001

Diversifying Your Bond

Continued from page 1

higher level of return, you must typically take on more risk. In ascending order of reward, the sectors are:

- **U.S. Treasuries.** Backed by the federal government's authority to print money and the U.S. economy's long-term history of moderate to low inflation, Treasuries offer the highest level of safety and the lowest yield.
- **Federal agency bonds.** These include bonds issued by mortgage agencies backed by the federal government, including Ginnie Mae, Fannie Mae, and Freddie Mac. Historically, these bonds pay higher yields than same-maturity Treasuries, since none of these agencies are backed by the full faith and credit of the U.S. Treasury. (While the federal government did bail out bondholders in 2008 following the collapse of the mortgage-backed bond market, there is no guarantee that in the future the same thing will happen.)
- **Municipal bonds.** These are issued by nonfederal governments and agencies. Because they have the legal power to tax or charge fees, as an asset sub-class they are regarded as second to Treasuries in safety. As a result, they can pay a higher after-tax rate of return than other types of bonds. Because the income they generate is usually exempt from federal and sometimes state and local income taxes, investors in higher tax brackets can earn higher after-tax income than they can from other types of bonds.
- **Corporate bonds.** These actually fall into two categories: investment-grade or high-quality corporate bonds and high-yield corporate bonds, also known as junk bonds. Corporate bonds offer higher yields than Treasuries or municipal bonds; but because their issuers are business enterprises, they present more risk. Junk bonds offer the highest yields but are issued by companies in financial distress — those that pose a greater risk of going out of business before the bonds mature.
- **Foreign bonds.** This is really a sprawling category of issuers, since it includes national governments and corporations and countries in both the developed world and emerging markets. The common additional risk element across all these subcategories is currency risk — the possibility the value of the foreign currencies will fall against the dollar, reducing the relative value of the bond.

Riskier Credit and Longer Maturities Mean Higher Yields

The lower the credit ratings and the longer you go out in maturity, the higher the interest rates you'll find. That's because there are greater risks an issuer won't be able to make its payments or inflation and interest rates will be higher and bondholders will be stuck with below-market yields.

The purpose of diversification in both stocks and bonds is to fine-tune the trade-offs investors make between risk and reward potential. With interest rates near historic lows, many bond investors have been tempted to reach for higher yield by taking on more risk in the form of lower-rated issuers and longer maturities.

With literally thousands of different bonds in the market, it's a significant task to find the best mix of issuer, credit, and maturity. Please call if you'd like to set up a portfolio review.

Consider a Bond Tent

The good news is you finally saved enough to retire and now have a large portfolio. The bad news? If the market takes a serious downturn, the impact on your portfolio could be a disaster. The money you thought you would have to live on for the rest of your life could end up falling short.

History has shown that the sequence of returns generated by a portfolio from one year to the next can hugely affect the total return generated over time. While long-term average returns determine how much money you make, the timing of those returns is equally important.

For example, if you retire during the bottom of a bear market, you will see your holdings rise as the market recovers, but you will also see the overall portfolio growth reduced because of the amount of money withdrawn in early retirement.

An important strategy to consider is building a bond tent before you retire. This strategy increases the allocation of bonds during the 10 years or so prior to retirement, and then the bonds are sold from this portion of your portfolio during the first 10 to 15 years of retirement, providing you with an income stream.

The reason this strategy is called a bond tent is that if you looked at it on a line graph, the bonds in the portfolio steadily rise until they reach a peak at retirement and then fall as the bonds are sold, which makes a tent shape.

The strategy works by reallocating a traditional 60/40 mix of stocks and bonds to an allocation of 50% or 60% in bonds by the time you retire.

The bond holdings are then sold during the first half of retirement until the original mix is once again reached. This provides portfolio protection against major losses due to market downturns in the first half of retirement. The portion of your portfolio that is still in stocks will continue on the path for long-term growth to fund your later years of retirement as well as provide protection against inflation.

Please call if you'd like to discuss bond tents in more detail.

Incorporating Bonds

Continued from page 1

dates, because the yield on bonds tends to increase as maturity dates lengthen. However, if you purchase a long-term bond and sell it before maturity, interest rate changes can significantly affect the bond's market value. Although you can't control interest rate changes, you can limit the effects of those changes by selecting bonds with maturity dates close to when you'll need your principal.

Determine your risk tolerance. Typically, the higher a bond's return, the greater its risk. Thus, U.S. Treasury securities, which are considered one of the safest bonds, typically carry lower interest rates than municipal or corporate bonds. Make sure you understand the risks involved before purchasing a specific bond.

Understand the tax ramifications. Different types of bonds are taxed differently. Interest income from U.S. Treasury securities is exempt from state and local income taxes but is subject to federal income taxes. Interest income from municipal bonds is exempt from federal income taxes and typically state and local income taxes for residents in the issuing state. Interest income from corporate bonds is subject to federal and state income taxes. Investors in higher marginal 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 maturity date, credit rating, call provisions, coupon rate, yield to maturity, price, and tax ramifications of interest income.

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

How and Why to Build a Bond Ladder

While bonds are subject to several types of risk, two of the main types are interest rate risk, or the risk that interest rate changes will change your bond's value; and reinvestment risk, or the risk that interest and principal cannot be reinvested at the current bond's interest rate. It is difficult to simultaneously reduce both risks, since a rise in interest rates reduces reinvestment risk and increases interest rate risk. Thus, you need to find a balance between the two risks.

Using a bond-ladder strategy can help investors strike this balance. The idea of a bond ladder is simple: instead of investing in bonds that all mature at roughly the same period of time or in a haphazard pattern of maturities, you spread out your portfolio 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.

For instance, a $100,000 portfolio might consist of 10 different bonds of $10,000 each, maturing in 10 consecutive years. When a bond matures, the principal is reinvested in another bond at the bond ladder's longest maturity date (10 years in this example).

If interest rates are higher at that time, your annual bond income will go up; if rates go down across the board, your income will still benefit from relatively higher rates on the rest of your portfolio. In either case, because 80% of your portfolio is still resulting in the same cash flow, your annual income won't change much, which makes your life more predictable than if all your bonds matured in any single year.

Building a Laddered Portfolio

To build a laddered bond portfolio, there are four basic, interrelated decisions to make:

- **Decide on the average maturity.** This will be an arithmetic average of the maturities you use to build your portfolio, which will determine your portfolio's overall price sensitivity to changes in interest rates.
- **Decide on how many rungs your portfolio will have.** This will determine how much of the span of available interest rates you'll be capturing (shorter maturities tend to come with lower interest rates and longer maturities with higher rates).
- **Decide how many years apart each rung will be.** This will determine how often you'll be reinvesting in the long-maturity end of your portfolio. The closer together the rungs, the more often you'll be reinvesting at current market rates for the longer bonds. Depending on which way rates move, this can help or hurt you.
- **Decide on the sector or sectors of the bond market you want in your portfolio.** Do you want safety? Then go with U.S. government bonds. Do you want tax-exempt income? Then go with municipal bonds. Do you want a higher level of interest than either of these sectors provide but still want financially reliable issuers? Then go with high-grade corporate bonds.

The major advantage to laddering is to smooth out the changes in the bond income you receive year to year, thus making it more predictable. But there are also downsides to laddering. One is that you will have more transactions than a portfolio with one, far-off maturity date.

It could also generate less income than if you put all your money into the highest-yielding maturity available. The trade-off is that if rates rise significantly long before your bonds mature, you're stuck with all of your money earning less than if you were to reinvest funds from maturing bonds in the higher yields.

FR2017-0217-0001

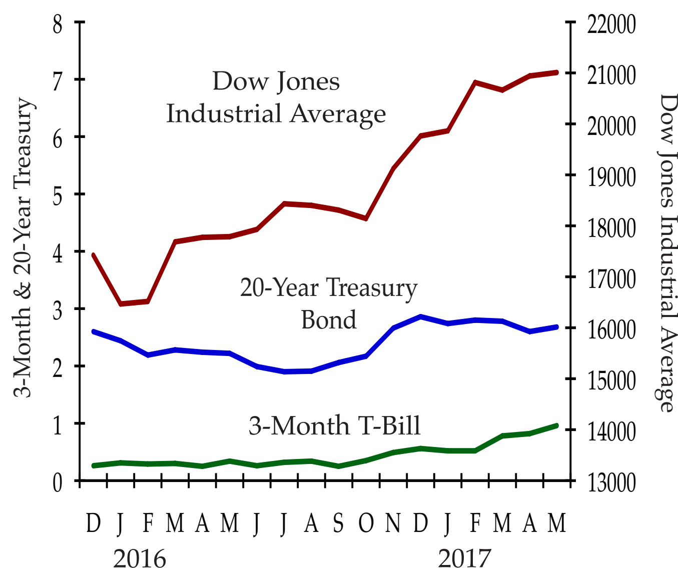
Business Data

Indicator	Mar-17	Apr-17	May-17	Dec-16	May-16
	Month-end				
Prime rate	4.00	4.00	4.00	3.75	3.50
3-month T-bill yield	0.78	0.82	0.96	0.56	0.34
10-year T-note yield	2.42	2.23	2.27	2.55	1.82
20-year T-bond yield	2.78	2.60	2.68	2.86	2.22
Dow Jones Corp.	3.22	3.09	3.04	3.17	2.89
GDP (adj. annual rate)#	+3.50	+2.10	+1.20	+2.10	+0.80

	Month-end			% Change	
Indicator	Mar-17	Apr-17	May-17	YTD	12-Mon.
Dow Jones Industrials	20663.22	20940.51	21008.65	6.3%	18.1%
Standard & Poor's 500	2362.72	2384.20	2411.80	7.7%	15.0%
Nasdaq Composite	5911.74	6047.61	6198.52	15.1%	25.3%
Gold	1244.85	1266.45	1266.20	9.2%	4.5%
Unemployment rate@	4.70	4.50	4.40	-4.3%	-12.0%
Consumer price index@	243.60	243.80	244.50	1.3%	2.2%
Index of leading ind.@	126.20	126.50	126.90	2.3%	2.4%

— 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 2015 to May 2017



News and Announcements

Consider Maturity Dates

Bonds can be purchased with maturity dates ranging from several weeks to several decades. Before deciding on a maturity date, review how that date affects investment risk and your ability to pursue your investment goals.

Typically, yield increases as the maturity date lengthens, since you assume more risk by holding a bond for a longer time. Investors are often tempted to purchase bonds with long maturity dates to lock in higher yields, but that strategy should be used with care. If you purchase a long-term bond knowing you'll need to sell before the maturity date, interest rate changes can significantly affect the bond's market value. Two fundamental concepts about bond investing apply:

- **Interest rates and bond prices move in opposite directions.** A bond's price rises when interest rates fall and declines when interest rates rise. The existing bond's price must change to provide the same yield to maturity as an equivalent, newly issued bond with prevailing interest rates. You can eliminate the effects of interest rate changes by holding the bond to maturity, when you will receive the full principal amount.
- **Bonds with longer maturities are more significantly affected by interest rate changes.** Since long-term bonds have a longer stream of interest payments that don't match current interest rates, the bond's price must change more to compensate for the interest rate change.

Although you can't control interest rate changes, you can limit the effects of those changes by selecting bonds with maturity dates close to when you'll need your principal. In many cases, you may not know exactly when that will be, but you should at least know whether you are investing for the short, intermediate, or long term. Please call if you'd like to discuss bond maturities in more detail.

FR2017-0217-0001