Independent Investor

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Understanding and Managing Risk in a Bond Portfolio

As interest rates spiked in the second quarter of this year, many bond investors shifted gears from intermediate and long-term bonds to bonds with shorter maturities. The relationship between interest rates and bond prices is just one of many potential risks associated with bond investing.

Why Consider Bonds?

Generally, there are two reasons for considering investments in bonds: diversification and income. Bond performance does not typically move in tandem with stock performance, so, for example, a downturn in the stock market could potentially be offset by increased demand for bonds. Some investors consider the bond market as a safer haven for their money during periods of stock market uncertainty.

Understanding the Risks

In addition to potential rewards, bond investors should be aware of some potential risks.

- Interest rate risk: Bond prices tend to drop when interest rates rise, and vice versa. This inverse relationship is referred to as interest rate risk, which may be a particular concern to investors who do not plan to hold a bond to maturity. A premature sale while rates are rising could result in a loss of principal. Exposure to interest rate risk increases with the length of a bond's maturity. Issuers generally pay higher yields on longer-term bonds than on those with shorter maturities.

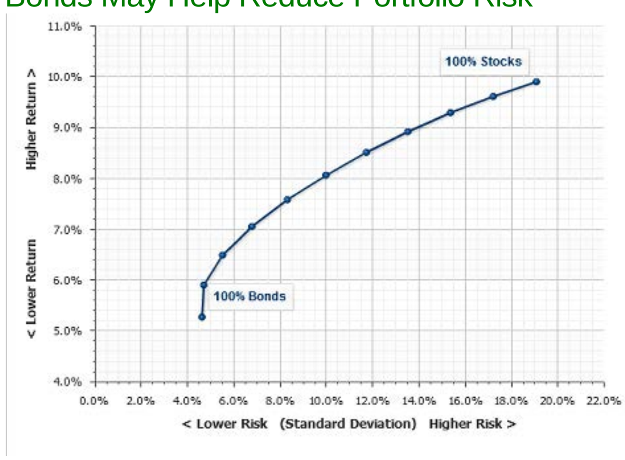
- Call risk: A low interest rate environment may expose bondholders to call risk, the risk that an issuer may redeem a bond before its stated maturity. Issuers typically call bonds when interest rates drop, allowing them to pay off higher-cost debt and issue new bonds at a lower rate. Bonds paying higher yields are most susceptible to call risk.

- Inflation risk: Inflation risk is the risk that the income produced by a bond investment will fall short of the current rate of inflation. (For example, if your fixed-income investment is yielding 3% during a period of 4% inflation, your income is not keeping pace.) The comparatively low returns of high-quality bonds, such as U.S. government securities, are particularly susceptible to inflation risk.

- Market risk: If an investor is unable to hold an individual bond through maturity—when full principal is due—market risk comes into play. If a bond's price has fallen since acquisition, the investor will lose part of his or her principal at sale. To help mitigate exposure to market risk, investors should evaluate their overall cash flow projections and fixed expenses between the time they plan to purchase a bond and its maturity date.

- Credit risk: Credit risk is the risk that a bond issuer will default on a payment before a bond reaches maturity. To help investors make informed decisions Standard & Poor's, Moody's Investors Service and other independent firms publish credit-quality ratings for thousands of bonds. The upside of a poor rating is greater reward potential. Issuers of lower-rated bonds usually reward investors with higher yield potential for accepting the relatively greater risks. As a rule of thumb, bonds issued by corporations or municipalities with a triple-B rating or higher are called investment-grade bonds. Non-investment-grade bonds, with ratings as low as D, are sometimes referred to as junk or high-yield bonds because of the higher interest rates they must pay to attract investors.

Bonds May Help Reduce Portfolio Risk



Standard deviation is a historical measure of the variability of returns. If a portfolio has a high standard deviation, its returns have been volatile. A low standard deviation indicates returns have been less volatile. This chart illustrates how a hypothetical combination of stocks and bonds would have helped reduce overall portfolio risk without potentially sacrificing too much in the way of returns during the period from January 1, 1926, through December 31, 2012.

Sources: Standard & Poor's; the Federal Reserve; Barclays Capital. Stocks are represented by the total returns of Standard & Poor's Composite Index of 500 Stocks, an unmanaged index that is generally considered representative of the U.S. stock market. Bonds are represented by a composite of the total returns of long-term U.S. government bonds, derived from yields published by the Federal Reserve, the Barclays Long-Term Government Bond and the Barclays U.S. Aggregate index. Individuals cannot invest directly in any index. Past performance is not a guarantee of future results. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Your results will vary. (CS000026)

Risk Management Options

To counter the risk of inflation, individuals can purchase inflation-protected government securities and bonds convertible to stock. Inflation-protected securities include 10-year Treasury notes whose redemption value is subject to adjustment every six months based on changes in the Consumer Price Index. Because of the inflation-protection feature, the interest paid on the notes is likely to be less than that paid on fixed-rate 10-year Treasury notes issued at the same time.

Convertible bonds offer the holder the option to exchange the bond for a specified number of shares of the company's common stock. In return for the ability to share in possible appreciation of its stock, the bond issuer offers a lower rate than those available on non-convertible bonds. The market value of convertible securities tends to decline as interest rates increase and may be affected by changes in the price of the underlying security.

Other risk management approaches are more likely to suit investors with substantial bond holdings. Laddering is one such strategy to help smooth out the effects of interest rate fluctuations. "Laddering" involves setting up a portfolio of bonds with varying maturity dates ranging from shorter to longer term. For example, you might purchase equal amounts of Treasury issues maturing in one, three, five, seven and nine years, giving you an average maturity of five years. As the principal comes due every two years, you would reinvest that amount in Treasuries due to mature in 10 years, preserving the five-year average maturity. Such a rolling portfolio with staggered maturities has the potential to provide liquidity at specific intervals without having to sell into the market.

Another strategy is to construct a "barbell," in which a portfolio is invested primarily in short- and long-term bonds. In theory, the barbell structure allows the longer-term portion of the portfolio to take advantage of higher yields, while the shorter-term portion limits risk.

The bond market provides a wealth of fixed-income products to suit virtually every investment goal and risk level. Online resources, such as the [Securities Industry and Financial Markets Association (SIFMA)](), can aid research. Still, choosing bond investments that pursue your specific financial needs can be a complicated undertaking, and the assistance of investment and tax professionals is advisable when managing the risk and reward potential of your bond investments.

There is no assurance that the techniques and strategies discussed are suitable for all investors or will yield positive outcomes. The purchase of certain securities may be required to effect some of the strategies. Investing involves risks including possible loss of principal. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. TIPS: CPI might not accurately match the general inflation rate; so the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPs do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.