

Special all-bond issue

A fixed-income primer

Here is a quick overview of bond types, concepts and terminology.

Bonds are securities representing a debt. When you buy a bond you are essentially loaning money in exchange for interest payments. Unlike stocks, bonds have a maturity date, when the loan will be paid off.

Treasury securities are issued by the U.S. government and include bonds (long-term), notes (intermediate-term) and bills (up to one year).

Municipal bonds are described in the article to the right.

Corporate bonds are issued by private companies.

Zero-coupon bonds do not pay interest. Rather, they are sold at a discount and redeemed at full value.

Convertible bonds are hybrids in that they may under certain conditions be converted into stock.

Some bonds have a variable interest rate tied to an inflation index, which protects you from being left behind when rates rise. In exchange for this protection they will pay a lower interest rate than a comparable bond without this feature.

A bond is **callable** if the issuer has the right to redeem it prematurely. The issuer will often do so if interest rates have dropped and it can refinance at a lower rate.

CDs are usually issued by banks and are FDIC-insured

You can purchase individual bonds either directly from the issuer or on the secondary market. But this carries certain risks (see the accompanying article to the right). Some of these, such as liquidity or event risks can be mitigated by investing in bond funds or ETFs.

Investing in tax-free securities

How would you like an investment that pays interest but where you never have to pay taxes on the income? That's the attraction of municipal bonds.

Municipal bonds, usually referred to as "munis" are issued by state and local governments and the interest they pay is not subject to federal income tax. Certain bonds are also not taxed at the state level – these are called double tax-exempt.

So what's the catch? The most obvious is that munis usually pay lower interest rates than taxable bonds of similar maturity and quality.

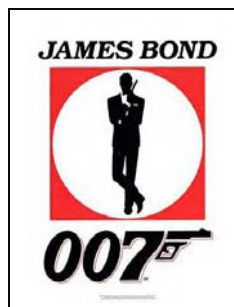
When evaluating whether munis

make sense for you, you need to look at what you could earn on taxable bonds of similar quality and maturity, then subtract out the taxes you would

have to pay. For example, if a taxable bond is yielding 6% and you are in the 25% marginal tax bracket, your net after-tax yield would be 4.5%. If a similar muni bond yields more than that it could be a better investment. Depending on

the particular bond you may also need to take state income taxes into consideration.

Please see *Munis* on Page 2



Bond investing: Riskier than you might think

While many investors focus on stocks and give little thought to investing in bonds, allocating a portion of their portfolios to bonds is usually advisable. These fixed-income investments can provide liquidity and stability to a portfolio, and also create a steady stream of income for retirees or others who need fixed income to meet current expenses.

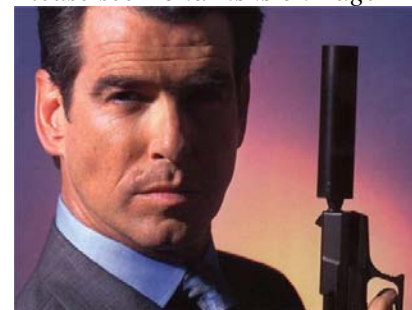
Many investors think of bonds as very safe investments that never lose value. However, several types of risk might be present for someone investing in individual bonds or bond mutual funds. Anybody who owns bonds, or is planning on doing so, should understand these risks.

♦ **Interest Rate Risk.** When interest rates rise, the value of a bond (or bond mutual fund) falls, and vice-versa. This is because if you own a bond paying 5% interest and interest rates then rise so that bonds of

comparable quality and maturity are paying 6%, you will have to lower the price of your bond to induce someone to buy it from you. This risk is not a factor if you hold an individual bond until its maturity.

♦ **Credit Risk.** All else being equal, the lower a bond's credit rating, the higher its stated interest rate should be to compensate investors for the added risk assumed. "Investment-Grade" bonds are those rated in one of the top four highest rating categories used by the major credit

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Munis

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You may see reference to a so-called tax-equivalent yield when looking at muni-bond or bond-fund information. That's the rate that a taxable bond or fund would have to pay to equal the muni on an after-tax basis. The formula is simple:

$$\text{tax equivalent rate} = \frac{\text{taxable yield}}{(1 - \text{tax bracket})}$$

Beware, however, that when the tax-equivalent rate is quoted for a tax-free investment it is usually calculated for an investor in the highest marginal tax bracket, currently 35%. So while it may make sense for a wealthy investor, you will need to do your own calculation if you are in a lower tax bracket. ❖

Bond risks

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rating firms. Bonds rated below the top four categories are considered to be speculative investments.

- ♦ **Reinvestment Risk.** This is the risk that interest rates might be lower at the time you receive and reinvest principal and interest payments in the future.
- ♦ **Inflation Risk.** Unless a bond has an inflation component built into its interest rate (such as TIPS or I-Bonds), inflation will affect the "real" return earned by an investor – the interest earned less inflation.
- ♦ **Event Risk.** This is the risk that something unexpected could occur that impacts the ability of the bond issuer to repay. Adverse events – such as financial difficulties or a company's product becoming obsolete – could also result in the company's financial rating being lowered, which would decrease the values of the company's outstanding bonds.
- ♦ **Liquidity Risk.** Generally, less-liquid bonds cost more to buy and sell because they are not as easy to trade. The costs of trading – such as bid/ask spreads and commissions – can be substantial and can drastically lower the bond's effective yield.

One very important thing to keep in mind is that the longer the time until a bond matures, the higher its inflation, interest rate, and reinvestment rate risks are.

As you can see, bond investing is not as much of a sure thing as you might have thought. Perhaps you are taking on more risk than previously thought with the fixed income portion of your portfolio. ❖

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