Fixed Income Blues

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In February's edition of *Fiscal Fitness*, we profiled several examples of stocks that can surface as bargains in today's uncertain equity markets. This month, we switch gears to give the bond market equal time. This discussion should appeal to individuals on fixed incomes, those in search of a safe, short term "parking place" for funds, or anyone looking to diversify their portfolio. We'll also explain the different types/strategies of fixed income investing and help you determine the suitability of different investments. Finally, we'll expose you to our crystal ball and discuss some interest rate scenarios and how it may affect your investment strategy.

When most people think of fixed income, Certificates of Deposit (CD's) and Money Market accounts usually come to mind. Those instruments are perceived as safe and pay a fixed rate of return. Compared to stocks, fixed income is like comparing a turbocharged engine to a golf cart. Safer, but accidents still happen. Typical money markets are currently paying 1.5% while 5 year CD's are yielding 4–5% - quite paltry given the timeframe. These investments appear safe and secure but the risks are not quite as apparent. Locking into low interest rates can expose one to "interest rate risk" – the risk that the return will not keep pace with inflation. For this concern, we feel there are better risk-considered alternatives than money market accounts or CDs. For example, investment grade corporate bonds (grade A or better) with no more than a 5-6 year maturity can yield 6.5 – 8% or more depending on the company. More risk? Yes, but that can be mitigated by researching the credit worthiness of the issuer company. Two caveats with buying individual bonds: These are only suitable for investors willing to spend at least $10,000 per bond and diversify over at least 5-10 bonds. Also, use a reputable bond dealer and watch the 'markup' (commission) charged. For investors with smaller amounts, consider a quality, corporate bond mutual fund.

Mortgage bonds (i.e. GMNA, FNMA, etc.) also offer more appealing interest rates and are a play on the housing market. They are backed by a guarantee of the U.S. government. Because of their complexity, you should consider buying mortgage bonds in a mutual fund. While the government guarantee eliminates the credit risk, these bonds, like all medium to long-term bonds, bear a *market risk* if long-term rates increase. The U.S. government also sells Treasury bills, notes and bonds, which are direct issues of the Government. The difference is the maturity of the issues – treasuries being the shortest and bonds, the longest. Unfortunately, while the credit risk of these issues is nil, the current returns aren't much higher than CD rates.

Some investors might want to investigate investment grade preferred stocks that offer attractive yields with limited volatility. Usually offered around $25/share and will pay 7-8%in the form of quarterly dividends. Think of them as a hybrid between stocks and bonds but also remember that the dividends can be cut.

Lastly, investors in higher tax brackets should consider municipal bonds. The state of Indiana provides triple tax exemption (federal, state, local) on other states' municipal bonds. Again, consider the municipality and project's credit worthiness (some bonds are insured) – avoid California and New York state bonds. For higher income earners, the taxable equivalent yield may be much higher than a taxable corporate bond.

Given the extremely low interest rate environment currently, more likely than not rates will increase in the next 6-12 months as the domestic economy regains momentum. For this reason, we caution locking into any fixed income vehicle that matures beyond 5 years. Corporate bonds may offer the best deals once the economy starts a recovery. High yield (aka junk) bonds now offer compelling yields relative to U.S. treasury bonds. While the risk is higher, investors can be rewarded in two ways: locking into an attractive, higher (9-10%) interest rate and possible capital appreciation if the issuer's financial condition improves. High yield bonds typically do very well at the dawn of an economic expansion. Again, we recommend high yield bond mutual funds/closed-ended funds, not individual bonds to minimize risk. Prudent investors should consider committing 5-10% of their portfolio to this area.

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