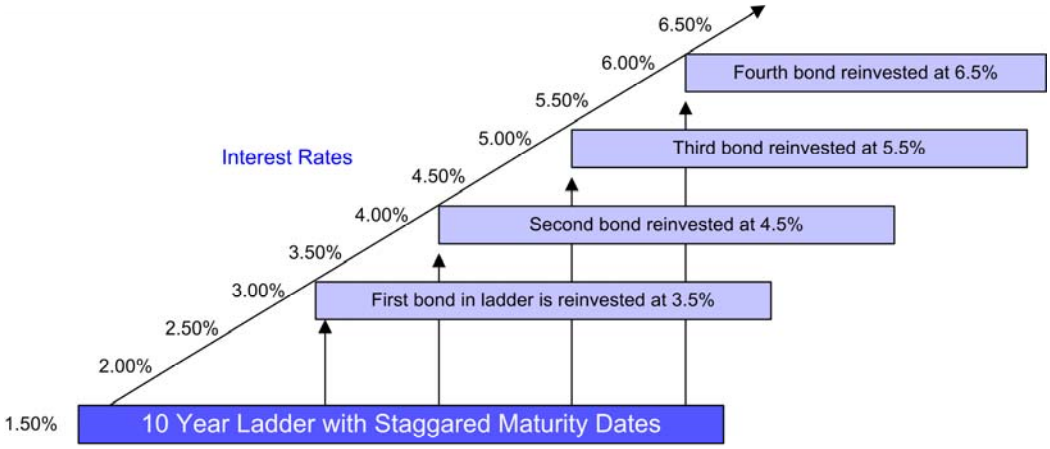
Bond Ladders

Generating Income with Bonds

Client Education: Strat-BL

Strategy Highlights

- Minimize Inflation Risk
- Reduce Holding Period Risk
- Reduce the impact of interest rate fluctuations
- Generate better total return
- Encourage Regular saving/investing



Managing Risk

Even though it's our ability to take risk that helps earn greater returns in the market, most investors are never quite comfortable with risk. For investors who don't need to take additional risks, the answer most often, is to create a laddered bond portfolio- consisting of Corporate, Government, or Municipal Bonds. Depending on the clients' risk tolerance and tax status, certain types of bonds may be preferred.

The "ladder" is created by staggering the maturity dates of each bond in the Portfolio. By diversifying the maturities among several different bonds in client portfolios, we are able not only to create a steady flow of income, but also are positioned to react to changes in the interest rate environment throughout the years of the ladder (See Illustration Above).

When individual bonds either mature or are called, the principal is reinvested in bonds that are returning the best rates along the maturity curve, which is usually the longest maturity of your ladder.

The strategy is very simple and can be used in both a rising and falling rate environment by either lengthening or shortening the duration of the ladder as rates change over time. Regardless of the perceived safety of the strategy, there is still a bit of psychology involved- In a rising rate environment however, investors are reluctant to buy anything but short-term bonds and CDs because they don't want their money tied up long term if interest rates continue to rise. They also don't want to risk being in longer-term bonds and see prices get punished as rates climb. For this reason, a bit of patience is required.

Our responsibility goes beyond prudently managing client assets; we are also compelled to help educate clients and manage their expectations. For this goal to be accomplished, it is important for our conservative clients to understand how bond ladders work.

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The Yield and Market Value

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."

-Warren Buffett

A bond's yield is directly related to not only the fed funds rate, but also its maturity- in a normal market environment, the longer the maturity, the higher the yield.

The Fed Funds rate, which represents the overnight lending rate between banks, is the base rate for most US debt instruments and has fluctuated from 1% to 19% since 1954. Of course, there are maturity and risk premiums that add to the final yield of the instrument, but it is critical to understand the base rate because it will directly affect the market value of one's bond portfolio.

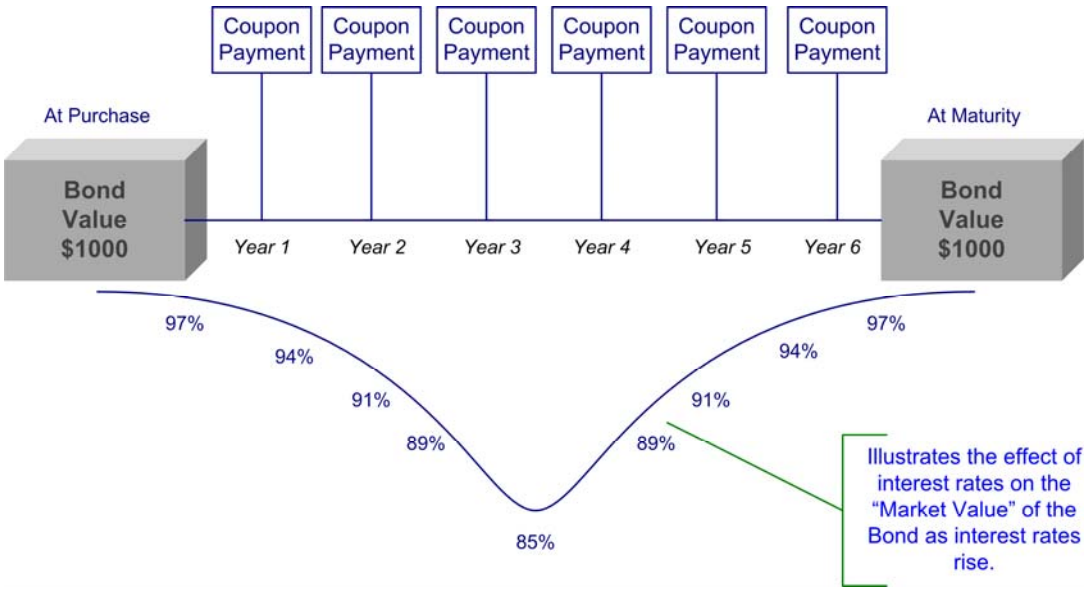
Another fact that should be understood is that while bonds are considered a "safer" investment than individual equities, they too are traded on a market consisting of buyers and sellers.

If for instance, we buy a bond maturing in five years that pays a 5% coupon and interest rates increase significantly immediately after we purchase our bond, the market value of the bond will decline. The reason of course is that current bond buyers won't want to buy a 5% coupon, when they are now able to buy a new issue that pays 7% (for a similar maturity), thus the market value of the bond goes down.

At the same time, the pricing pressure on existing bonds has the effect of pushing the actual yield-to-maturity up while the price of the bond goes down.

The pressure created by an upward change in interest rates does not affect the coupon payments, but as the portfolio is "marked to the market", the market value in client accounts declines temporarily and is eventually lifted again by the "maturity pull" (*see below*).

For this reason, investors who use a laddered strategy should be committed to holding each issue to maturity. If market conditions or client objectives change, maturing issues can always be reinvested into another asset class.



Note: *In a declining interest rate environment, the portfolio would typically appreciate in market value and begin to decline back to par pricing as each issue matures.*

Disclaimers and Important Disclosures

Shane Merritt is the Principal of Merritt Capital Management, Inc. an independent firm located in Gloucester, Massachusetts. Securities are offered through Raymond James Financial Services, Inc. Member FINRA/SIPC.

Market values of individual bonds change as market conditions change. There is no assurance that this or any strategy will ultimately be successful or profitable nor protect against a loss. Strategies discussed may not be suitable for all investors.

We hope this information has been both helpful and educational. If you would like further information regarding Bond Ladders or more sophisticated investment strategies, please call us at:

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Further Reading

Bill Gross on Investing, *by William H. Gross*

Investing in Fixed Income Securities: Understanding the Bond Market, *by Gary Strumeyer*

Fixed Income Strategy: A Practitioner's Guide to Riding the Curve, *by Tamara Henderson*

Glossary:

Coupon Rate: The annual interest rate paid to bondholders, expressed as a percentage of par value. A $1,000 par value bond with a 7% coupon pays $70 annually, or $35 every 6 months.

Duration: Duration is a measurement of how long in years it takes for the price of a bond to be repaid by its internal cash flows and also indicates how interest rate changes will affect bond prices. The duration is shorter than the stated term to maturity on all securities except zero coupon bonds, for which they are equal.

Maturity: The date on which the principal amount becomes due and payable to the bondholder.

Par Value: The principal amount of the bond due the holder at maturity. Most bonds trade in denominations of $1,000 par value.

Price: Bond prices are quoted as a percentage of par value. A $1,000 bond trading at 90 1/2 is priced at 90.5% of $1,000, or $905 per bond.