

IT'S YOUR MONEY!

Week 7: *Fixed Income Investing*



WHAT IS FIXED INCOME?

**A loan to company or government →
payback with interest**

– Terms of the investment return are fixed

- Calculation of interest rate
- Frequency of interest payments
- Termination date
- Return of principal



Examples...

- **CDs**
- **US Treasuries / TIPS**
- **Mortgage-backed**
- **Corporate bonds**
- **Municipals**
- **Convertibles**
- **Zero-coupon**
- **International**



BENEFITS AND RISKS

Benefits...

- **Dependable Income**
 - Semi-annual payments
 - Higher yield than cash
 - 2.5 – 3.0% above inflation rate
 - 5 – 6% over time
- **Reduce volatility**
 - Counter-cyclical to stocks
 - Downside protection
 - Diversification of portfolio
- **Increase overall return**
 - While reducing risk

Risks...

- **Credit (default) risk**
- **Interest rate risk (price volatility)**
- **Re-investment risk**
- **Inflation**



BOND PRICING

Prices are quoted as a percentage of *Face Value*

- a bond priced at 98 will cost \$980 (discount)
- A bond priced at 102 will cost \$1,020

You purchase a 5-year bond yielding 3%:

- If rates rise to 4%, your bond will trade at a discount
- If rates fall to 2%, your bond will trade at a premium

Normal trading increments of \$5,000 face value

- Trading blocks of \$25,000 to \$1 million can bring better pricing

BOND INTEREST RATES

Coupon Yield *applied to face value*

- Only tells you how much your semi-annual payments
- Useless without knowing what price you are paying for the bond

Current Yield *coupon yield/current price*

- Links the coupon to current price, but doesn't consider any premium or discount
- Creates false impression of high returns when bonds are priced at a premium
- Creates false impression of low returns when bonds are priced at a discount

INFLATION

How will inflation affect your returns?

- What if inflation rises higher than bond yield?

Fixed income is fixed. *The more fixed income you have, the greater the chance of outliving your money*

For Example...

- **Stamps in 1980 – 15 cents**
- **Stamps in 2010 – 44 cents**

How will you buy a stamp 30 years from now if your income is fixed???



CERTIFICATES OF DEPOSIT

- Also known as “time deposits”
- Maturities range from 30 days to 5 yrs

Advantages

- FDIC insured return of principal
- Convenience
- Available in small increments

Disadvantages

- Rates are driven by the bank’s need for funds and may not reflect current market
 - Penalty may be assessed on early withdrawal
- **How to buy CDs...**

BONDS

US Treasury Securities

Treasury Inflation Protected Securities

Mortgage Backed Securities

Corporate Bonds

Municipals

Zero-Coupon Bonds

Convertibles

International



BUYING AND SELLING BONDS

No Central Exchange

- Bonds are generally bought and sold through brokerage firms
- Different brokerage firms may offer different price quotes for the same bond
- A brokerage firm's desire to buy or sell a bond varies with the firm's current inventory of bonds
- Recognizing a 'fair price' requires market knowledge – quotes can vary significantly from broker to broker

more...

- **No Transparency** (no commissions?)
- Brokerage firms buy and sell from their own inventory – they own the bonds
- **Bid:** price a broker will offer to buy a bond
- **Ask:** price a broker will demand to sell the same bond
- **Bid/Ask Spread:** Difference between what brokerage firm paid for the bond and what firm sells to bond to you for
- You don't know the bid/ask spread



INDIVIDUAL BONDS VS. MUTUAL FUNDS

Individual Bonds

- **Hold to term**
- **Ladder them**
 - staggered maturities
- **Reduces risk...**
 - Credit, interest rate, re-investment, inflation

Disadvantages

- Hard to get diversified
- Shorter maturities result in lower returns
- Expensive to buy/sell
- Research is intensive
- No professional management

Mutual Funds

- **Diversification**
- **Professional management**
- **Liquidity – easy to buy and sell**
- **Convenience; stable distributions**

Disadvantages

- Fees (0.5% - 1.5%)
- Less direct control over investments
- No fixed yield or maturity date

BOND MUTUAL FUNDS

- **Types of Bonds**
- **Issuer:** Gov'ts, Agencies, Corps, Munis
- **Duration:** Short/Intermediate/Long term

Selecting Bond Fund, don't look at...

- Current yield,
- last year's performance

Watch Fees! low fee funds are the best long term performers

READ THE PROSPECTUS!

