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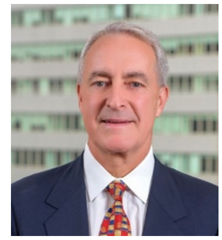
Thoughts for Investors



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Summer Newsletters to Clients

JULY 2004

– By Julie McCormick

Lately I have gotten many questions about bonds, and as Al is meeting with analysts today, I thought I could take the opportunity to give equal time to bonds. Some of the questions I have heard are; with the changing economic situation, world events and the presidential election coming up, is now a good time to invest in bonds? What if interest rates go up? How many bonds should I own? What about convertible bonds? Should we wait until after the election or the next fed meeting? Why do I want to lock in these rates? Before answering these questions, I think we should take a step back to look at the reasons for investing in bonds in the first place.

Why bonds?

Bonds are the "defense" to a stock portfolio's "offense" – the "insurance" in a portfolio. Bonds provide income and portfolio diversification. Bonds are supposed to be predictable. Like workers who don't expect to participate in the growth, bonds "punchin", pay their stated interest, and "punch-out" on the maturity date when the principal is returned. We invest in bonds when we want to know exactly where, when and how much interest we will be paid.

Contrary to popular belief, age does not make fixed income appropriate or inappropriate for an investor. Bonds generally finance specific goals such as retirement income, tuition payments or a house purchase. Even growth-oriented investors have these targeted purposes. It is a matter of defining how much money you need to meet specific requirements, which dictates how much you should have in bonds. Very often, for emotional reasons, people feel the "need" to own lots of bonds. This usually happens during times of declining stock markets (when, in fact, Al would tell you it is a better time to be buying stocks). In addition to inflation and lack of growth, many people don't have the large amount of capital needed to allow them to meet their goals with 100% of their portfolio in bonds. They must include other investments to assist in reaching their financial goals.

Bonds provide income, not profits

Since bonds are the "insurance" in the portfolio, you shouldn't expect them to generate "profits" or stock-like returns. Unfortunately, Wall Street creates all kinds of glamorized fixed income products in an attempt to provide a high return in addition to satisfying the desire for security. The only way to get significantly higher returns from bonds is to have interest rates decline significantly OR to take additional risk…as is the case with any investment. When it comes to bonds, the two main types of risk are credit risk (quality) or interest rate risk (bond value fluctuates with interest rate fluctuations.) When the potential for return increases, risk increases, the predictable insurance-like quality of bonds fades, and the mission of stability is unfulfilled.

Guessing interest rates - the crystal ball syndrome.

Many people waste time looking into their crystal balls, wondering if today, tomorrow or next year is when interest rates will finally peak and be the best time to invest in bonds. Waiting can be costly and can lead investors to react emotionally. Having a plan and sticking with it eliminates the tendency to be reactionary.

When building a portfolio we often use a laddered strategy. Laddering involves staggering maturities so that a portion of the portfolio matures each year. The proceeds are then reinvested at the end of the ladder. This consistent approach avoids speculating on changes in interest rates, since there has never been an accurate way to predict interest rates or inflation. Laddering allows investors to keep a steady stream of income and minimize the adverse effects of interest rate fluctuation.

In summary, is this is a good time to buy bonds? Absolutely, if you have something to “insure”, just as one would never drive a new car off the lot without insurance in place, nor, wait and hope that insurance rates get better.

The fundamental mission of bonds is to provide a predictable, steady stream of income. Interest rates will continue, as they always have, to move up and down on a daily basis. The lower yield of bonds is the cost of being predictable. Fixed-income products created to generate higher returns add risk and eliminate the steady, protective qualities of bonds. And of course, recognize that it takes a lot more capital to meet goals with low yielding, high quality fixed income investments.

Which leads back to what we have said many times before. Making a plan, reviewing it periodically, and sticking with it will help investors avoid making emotional decisions. How much you should own is dependent on how much you need to insure. Completing a financial profile with Ty will assist you in identifying an appropriate allocation of bonds for your situation.

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Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team’s approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

Thoughts for Investors is a quarterly newsletter written for clients since 1997 by this author. The purpose is two-fold. First, it is meant to help explain the investment philosophy that guides the author’s approach to portfolio management. Second, it is meant to remind readers of important behavioral skills that the author believes are necessary to help them become successful investors. The author welcomes comments and criticisms, especially if they can be shared for the betterment of all investors. Quotation is permitted with full attribution.

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