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Diversifying Your Bond Portfolio

Most investors understand the benefit of diversifying their stock portfolios: it's a matter of spreading your risk. But does the same principle apply to a bond portfolio? The simple answer is yes.

Bonds carry risk. As an asset class, bonds pose less risk than stocks for the simple reason that if and when an issuer goes out of business, bondholders take precedence over stockholders when it comes to distributing assets.

Here, we're talking about credit risk — just one of the several different kinds of risk bond investors face. It's impossible to eliminate this risk entirely from any bond portfolio: companies go out of business and pay bondholders pennies on the dollar, and governments — even sovereign national governments — can run into financial trouble and pay out later than scheduled or renegotiate their debt on terms that are less favorable to investors.

U.S. Treasuries' Safety Comes at a Cost

When it comes to credit risk, the outlier is U.S. Treasuries: Treasury bills, bonds, and notes. Backed by what is still regarded as the strongest, most stable government in the world, U.S. Treasury securities are considered the safest choice for receipt of timely interest payments and full redemption. So, Treasuries remain bond investors' best choice for minimizing the chances that they won't receive redemptions at the bonds' face value.

But because Treasuries are the safest bonds out there, they come with a downside: across the maturity spectrum, the interest rates Treasury securities pay are among the lowest you'll find. In other words, you trade income for safety — and

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On a Personal Note

In June, our family traveled to Europe in honor of Romy's graduation from high school. We began our journey in London, arriving on the infamous day of the massive fire that engulfed a residential high-rise building in the west end of the city. Despite this sad event, the rest of our time in London was uplifting and fun.

We stayed in Hyde Park and hit all of the landmarks that a family would want to see on their first trip to London — Buckingham Palace, Westminster Abbey, The Churchill War Rooms, Harrods, and more. I think one of our favorite activities was walking along the South Bank of the Thames River, beginning at the London Eye and ending at Borough Market where the London Bridge spans the river. The market had just reopened the day before, since it had only been a week earlier that the

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Diversifying

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not having the income you need to meet your goals has to be considered a risk.

So why diversify away from Treasury bonds? Not to control risk better, but to achieve higher income. And that's the principal reason for diversifying your bond portfolio: to achieve a better balance between risk and reward to match your needs and objectives.

There are basically three dimensions of bond diversification: issuer, credit quality, and maturity.

Different Issuers, Different Risks and Rewards

There are five major sectors of the bond market, and they're defined by the class of issuer. Each poses a different risk/reward profile. As in all financial markets, the lower risk you want, the lower your potential rate of return; to get a higher level of return, you must take on more risk. In ascending order of reward, the sectors are:

✔ **U.S. Treasuries.** Backed by the federal government's authority to print money and the U.S. economy's long-term history of moderate to low inflation, Treasuries offer the highest level of safety and the lowest yield.

✔ **Federal agency bonds.** These include bonds issued by mortgage agencies backed by the federal government, including Ginnie Mae, Fannie Mae, and Freddie Mac. Historically, these bonds pay higher yields than same-maturity Treasuries, since none of these agencies are backed by the full faith and credit of the U.S. Treasury. (While the federal government did bail out bondholders in 2008 following the collapse of the mortgage-backed bond market, there is no guarantee that in the future the same thing will happen.)

✔ **Municipal bonds.** These are issued by nonfederal governments and agencies. Because they have the legal power to tax or charge fees, as an asset sub-class they are regarded as second to Treasuries in safety. As a result, they can pay a higher after-tax rate of return than other types of bonds. Because the income they generate is usually exempt from federal and sometimes state and local income taxes, investors in higher tax brackets can earn higher after-tax income than they can from other types of bonds.

✔ **Corporate bonds.** These actually fall into two categories: investment-grade or high-quality corporate bonds and high-yield corporate bonds, also known as junk bonds. Corporate bonds offer higher yields than Treasuries or municipal bonds; but because their issuers are business enterprises, they present more risk. Junk bonds offer the highest yields but are issued by companies in financial distress — those that pose a greater risk of going out of business before the bonds mature.

✔ **Foreign bonds.** This is really a sprawling category of issuers, since it includes national governments and corporations and countries in both the developed world and emerging markets. The common additional risk element across all of these subcategories is currency risk — the possibility the value of the foreign currencies will fall against the dollar, reducing the relative value of the bond.

Riskier Credit and Longer Maturities Mean Higher Yields

The lower you go in credit ratings and the longer you go out in maturity, the higher the interest rates you'll find. That's because there are greater risks that an issuer won't be able to make its payments, or inflation and interest rates will be higher and bondholders will be stuck with below-market yields.

The purpose of diversification in both stocks and bonds is to fine-tune the trade-offs investors make between risk and reward potential. With interest rates near historic lows, many bond investors have been tempted to reach for higher yield by taking on more risk in the form of lower-rated issuers and longer maturities.

With literally thousands of different bonds in the market, it's a significant task to find the best mix of issuer, credit, and maturity. Please call if you'd like to set up a portfolio review. ❍❍❍

Avoid These 5 401(k) Plan Mistakes

A popular retirement vehicle in the United States, 401(k) plans bring millions of people closer to their dream retirement. While it's true that participation is the first step, simply putting money into a 401(k) plan won't guarantee a comfortable retirement. All too frequently, people make mistakes with their 401(k) plans that cost them more than they realize, sometimes preventing an early or on-time retirement. Consider these five common 401(k) mistakes and how you can avoid them:

1. Believing Simply Contributing to Your 401(k) Plan Is Sufficient

Again and again, people believe that spending carelessly is okay as long as they are also contributing to their retirement fund. Not true. Simply contributing to your 401(k) plan does not necessarily mean that you are going to have a comfortable retirement.

Your goal should be to contribute the maximum annual limit — $18,000 for people under 50 years of age and $24,000 for investors 50 years of age or older. Contributing at that level clearly isn't realistic for everyone, and certainly some level of contribution is better than nothing. But living well within your means today — taking control of your spending so you have some left over at the end of the month to sock away in a retirement fund — can mean a more comfortable retirement tomorrow.

2. Using Your 401(k) Plan as a Savings Account

When you go through a major life event, such as a job change, the birth of a child, sending kids to college, or a divorce, it can be tempting to cash out your 401(k) plan to get you through that rough patch. Indeed, the lure of the now can be difficult to resist, but the point of a 401(k) plan is to give yourself a comfortable tomorrow.

Withdrawing from your 401(k) plan today not only puts a dent in the balance that will compound over time, but if you're not yet at retirement age, the Internal Revenue Service may send you a hefty tax bill for withdrawing that retirement money early.

Here's an example. If at age 25 you cash out a 401(k) plan with a balance of $5,000, you would receive around $3,100, $5,000 minus 28% ordinary income tax ($1,400) and the 10% early withdrawal penalty ($500). However, if you kept that $5,000 invested until age 65 (assuming 8% annualized earnings), you could end up with more than $108,000 at retirement. *(This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment vehicle.)*

To the extent that you can, leave your 401(k) alone to grow until your retirement. Use other cash assets for those inevitable rainy days.

3. Fearing Diversification

Diversification is a risk-management technique that mixes a wide variety of investments within a portfolio. It's based on the idea that a mix of different investments may yield higher returns with lower risk than any individual investment.

A good rule of thumb is to invest more in equities the further you are from retirement, and then gradually increase your bond allocation over time to help make that shift from a growth orientation toward an income orientation. The point is this: a blend of investments is important and requires adjustments along the way.

4. Not Participating in a Company Match Program

If your bank gave you $10 every

time you deposited $10, would you accept that? That's what many companies offer through their 401(k) matching programs. Yet, surprisingly, many people don't participate.

Simply put, in almost every case, not participating in your company's 401(k) matching program does not make sense. Figure out how to budget your monthly take-home pay so that you can contribute at least as much as your employer will match (most match 50 cents or $1 for every $1 contribution, up to a certain percentage of the employee's salary).

5. Suffering Analysis Paralysis

Is your retirement fast approaching and the anxiety has you avoiding the details? Are you just out of college and feel as though you have a lifetime to accumulate enough for retirement? Whatever your situation, it is better to be prepared for retirement than not. The mistake here is either failing to tap the benefits a 401(k) plan offers (like company matching) or setting up contributions and then failing to pay attention to how they are allocated and making necessary adjustments.

If you feel like you may be making some of these mistakes or would simply like help preparing your investments for retirement, please call. ❍❍❍

On a Personal Note

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ISIS terrorist attack occurred there. As we enjoyed the eclectic assortment of foods, I could not help but feel a little bit wary as I watched my wife and children move about the crowds of people. We also stopped by the countless bouquets of flowers left on the south end of the London Bridge in memory of the people who perished that day. That evening we enjoyed some theater in the West End.

After a few memorable days in London, we flew to Amsterdam to begin the second phase of our trip — a river boat cruise down the Rhine with other families associated with Valmark Financial Group. In case I didn't mention it before, I had a productive year in 2016; and as a result, Valmark invited me and my family to join them on the Ama Waterways Sonata for a privately chartered week-long cruise. We set sail from Amsterdam and enjoyed stops in cities such as Cologne, Rudesheim, Heidelberg, Strasborg, and Basel. We especially liked sailing through the Rhine Gorge, a section of the river best known for its many medieval castles and palaces between Rudesheim and Koblenz, a day excursion to Paris, and the picturesque French city of Strasborg. But the most charming city of all to me was Amsterdam. This city of canals, windmills, and bicyclists makes you yearn for a simpler way of life. We were deeply touched by our visit to the Anne Frank house, which holds the hiding place where Anne wrote her famous diary during World War II.

As a financial planner, I often coach others about the need to set aside money for a better tomorrow. After this trip, I am going to remind those same clients about the importance of enjoying the present, too. I think we can be happier if we can learn to balance the two competing interests of living for today and planning for tomorrow.

This family trip to Europe is one I will treasure for a lifetime.

A Look at Bond Tents

An important retirement strategy to consider is building a bond tent. This strategy increases the allocation of bonds during the 10 years or so prior to retirement, and then the bonds are sold from this portion of your portfolio during the first 10 to 15 years of retirement, providing you with an income stream.

The reason this strategy is called a bond tent is that if you look at it on a line graph, the bonds in the portfolio steadily rise until they reach a peak at retirement and then fall as the bonds are sold, which makes a tent shape.

The strategy works by reallocating a traditional 60/40 mix of stocks and bonds to an allocation of 50% or 60% in bonds by the time you retire.

The bond holdings are then sold during the first half of retirement until the original mix is once again reached. This provides portfolio protection against major losses due to market downturns during the first half of retirement. The portion of your portfolio that is still in stocks will continue on the path for long-term growth to fund your later years of retirement as well as provide protection against inflation. ❍❍❍

Financial Thoughts

Women face five challenges when ensuring they have enough income for retirement.

1. **Fewer working years:** Women average just 29 years in the workforce compared to 38 years for men. The difference is due to time taken off to care for children and, to a lesser extent, elderly parents.
2. **Lower pay:** Professional women earn 28% less than professional men.
3. **Greater risk aversion:** Women tend to maintain higher cash allocations and lower stock and mutual fund allocations than men do.
4. **Longer lifespans:** Women age 65 outlive men of a similar age by 2.5 years. In situations where the wife outlives her husband, women live an additional 11.5 years following the death of their spouses.
5. **Health care costs are higher:** Women will spend $19,558 annually on health care once they turn 65, compared to $18,251 for men (Source: TIAA, October 2016).

Approximately 25% of parents have taken on debt to support adult children, and 60% of parents would keep working longer to support adult children (Source: *Money*, January/February 2017). ❍❍❍