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## Saving & Spending



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## Thinking About Bonding with Government Bonds?

**Look Before You Leap into the Arms of Uncle Sam's Securities as a Safe Alternative to the Stock Market**

By Brian L. Coughlan

With the stock market so fickle these days, the buzz around the water cooler has been to dump stocks and invest in Government bonds for "safety." Don't be hasty. Before liquidating your portfolio of stocks and stock mutual funds for this financial safe haven it's a good idea to learn more about investing in Government securities. Otherwise, your financial portfolio could face a double-dip reduction in its value.

Typically, when faced with fear and uncertainty about the financial markets, investor look for a safe place to put their money. This is called "a flight to quality," and it often leads to the purchase of Government securities. Government securities have several characteristics that give them increased safety. Their high quality stems from their backing by "the full faith and credit of the U.S. Government or its agencies." This means that for a Government security to become worthless, the U.S. Government or its agencies would need to default on their debt. Liquidity (meaning you can sell them at any time) and predictability of cash flows are other appeals of Government securities. Nevertheless. . .

### There's No Such Thing As 'Risk-Free'

As attractive as bonds are in times of stock-market volatility, when investing in them, it's important to understand that there are still risks, and they come in several flavors. "Event risk" is an unpredictable or unanticipated event, such as war, a Government scandal, bankruptcy, or economic collapse. "Principal risk" is the risk that the original investment, or principal, will not be repaid in full. (Return of principal is only guaranteed if a security is held to maturity. If a security is sold prior to maturity, the selling price is subject to changes in the interest rates.) Which brings us to the most common concern, "interest-rate risk," which reflects how changes in the prevailing interest rates affect the current value of your investment.

Simply put, when interest rates go up, bond values go down, and vice versa. Expectations of inflation and deflation—those things that keep Federal Reserve Board chief Alan Greenspan up at night—affect interest-rate levels. Inflation occurs when the general level of prices for goods and services rise, which

**Women investors nearing retirement tend to have lower risk tolerance levels, shorter investment time horizons, and they typically have a higher percentage of their portfolios invested in bonds.**

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leads to a decline in purchasing power and an overall increase in interest rates. When interest rates rise, the value of bonds (which are a reflection of the general health of the economy) decreases. Deflation, on the other hand, leads to a reduction of prices and interest rates, resulting in an increase in bond values.



Here's how this risk plays out: If you buy a \$100,000, 6 percent coupon, 30-year bond, at par (\$1,000 per bond), and interest rates rise 2 percent, the bond will be valued at \$77,380—a decrease of over 22 percent in value. Naturally, a subsequent investor would be willing to pay less for your 6 percent bond than for a similar bond with an 8 percent yield. Conversely, if you own a 6 percent bond and a new investment of the same type now yields 4 percent, an investor would be willing to pay more for your bond than for one with a 4 percent yield.

### So Where's the Security in Securities?

If your stock-market jitters have you so spooked that you want to take shelter in bonds, study your bond options carefully. Some do have built-in protections against fluctuating interest rates. Government offerings consist of several different types of securities, with maturities ranging from three months to 30 years. These include Treasury bills, notes, bonds, and agency issues, such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae).

**How can investors combat interest-rate risk while staying invested in bonds? Create a well-planned portfolio of laddered securities, leverage the use of inflation-sensitive bonds, or combine the two strategies.**



Look for issues that include inflation protection with principal safety. A few Government agency bonds also offer a step-up provision, which pays an initial coupon rate for the first period and higher coupon rates for the following periods. And the U.S. Treasury recently added a unique inflation-indexed security, called a Treasury Inflation Protected Security, or TIPS, which protects your principal. Unlike other notes and bonds, TIPS' interest and redemption payments are tied to inflation, and their principal value is adjusted in relation to the Consumer Price Index (CPI). Upon maturity, an investor will receive the par (or face) value of the security or the inflation-adjusted principal amount, whichever is greater. Inflation adjusts the principal value higher and deflation adjusts the principal value lower, but never below the par value. So you never lose your initial investment, as you could in the stock market.



As an added benefit, Treasuries and some agency issues are exempt from state and local taxes. For more information on Government securities, including current rates and how to buy them, visit [www.treasurydirect.gov](http://www.treasurydirect.gov) or [www.bondsonline.com](http://www.bondsonline.com).

### The Current Climate

Low interest rates and a flight to quality characterize the current economic and investing environment. This has driven bond prices higher and yields lower on high-quality bonds. The prevailing belief is that the U.S. economy will not experience deflation, but that there is a greater chance of some level of inflation in the future. If so, investors holding longer-term bonds would be exposed to greater levels of interest-rate risk. With this in mind, investors need to be well aware of their risk tolerance levels and investment time horizons. Younger women investors have the ability to take on higher levels of risk, due to their longer investment time horizons, and they usually have a smaller percentage of their portfolio





invested in bonds. Women investors nearing retirement, on the other hand, tend to have lower risk tolerance levels, shorter investment time horizons, and they typically have a higher percentage of their portfolios invested in bonds. Both groups would benefit from the following strategies.

#### A Plan to Prosper

How can investors combat interest-rate risk while staying invested in bonds? Create a well-planned portfolio of laddered securities, leverage the use of inflation-sensitive bonds, or combine the two strategies.

- A laddered portfolio is comprised of a series of bonds maturing at evenly spaced future dates. The resulting constant maturity of issues will allow an investor to reinvest at current rates and thus reduce interest-rate risk.
- Inflation-sensitive bonds, such as step-ups and TIPS, help negate the negative effect inflation has on bond values. Step-ups offer more immediate upward adjustments to income as the coupon rate is increased at regular intervals. TIPS offer annual adjustments to principal value to keep pace with inflation, which indirectly affects the amount of income paid. Since the principal adjustments are realized at maturity, the adjustments cannot be spent immediately, but they represent “phantom” income to the taxpayer.

These adjustments in interest rates and principal allow investors to reduce their investment risks associated with inflation. The same strategies work during deflationary times as well, as a way to avoid having a portfolio in strictly short-term securities. They allow an investor to earn a competitive yield in both rising and falling markets. And they can be used for women who are just starting to invest, as well as those nearing retirement.

**There is a chance of some level of inflation in the future. If so, investors holding longer-term bonds would be exposed to greater levels of interest-rate risk.**

For investors who are looking for safety, predictability, and liquidity, a properly structured portfolio of Government securities may offer benefits to match their objectives. But positioning a portfolio takes time and patience. Besides understanding bond basics, investors need to have a firm understanding of their personal investment time horizon and the interest-rate environment (short and long term). All that plus a well-thought-out plan will provide you with the security you seek—and can't find right now on Wall Street.

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