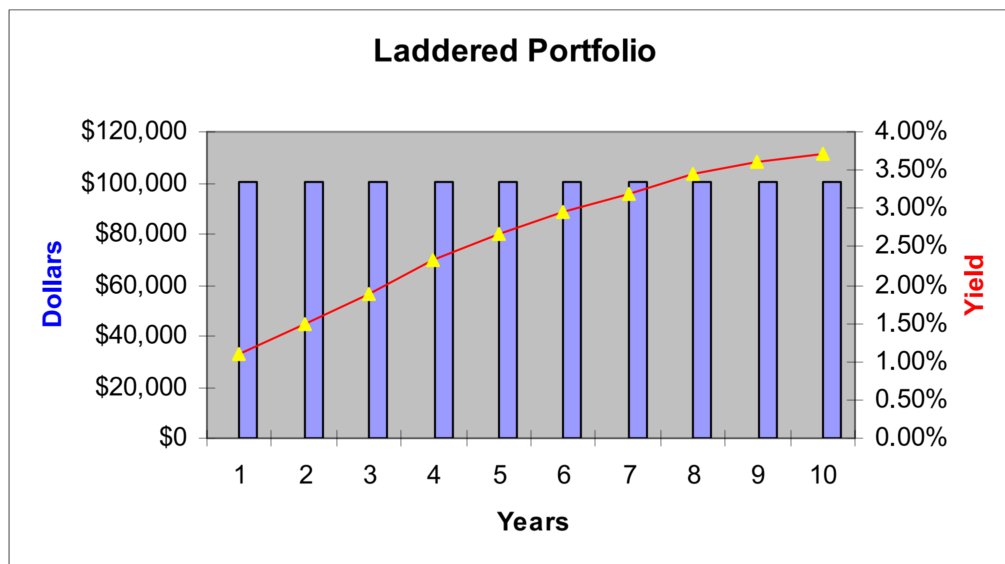
Help! Yields have fallen and they can't get up.

With current interest rates at near 45-year lows, it is hard for the average investor to make a buck. Couple this with the fact that the average investor has an aversion to investing in long-term bonds, because of the belief that an increase in interest rates is just around the corner, and it becomes nearly impossible to earn a yield level significantly above money market rates. So what can investors do to increase yield, but also ensure that when interest rates finally do get around that "corner," the portfolio is still able to invest at higher yields?

Well, there are several different strategies that can be used, each having their own benefits and drawbacks. Two of the most common strategies used by investors and money managers are the laddered portfolio and barbell strategies. Either strategy may be helpful for individual investors, as well as institutional, charitable and non-charitable entities.

So what exactly does laddering bonds mean? Well, picture a ladder standing upright. Now imagine each rung (step) being a different year (e.g. 2005, 2006, 2007...) and spreading out your investment dollars among various bonds in each of those years, with maturities ranging from one to ten years. As bonds mature in each of the years, a new rung is created in the 10th year, and the investor simply reinvests at current interest rates

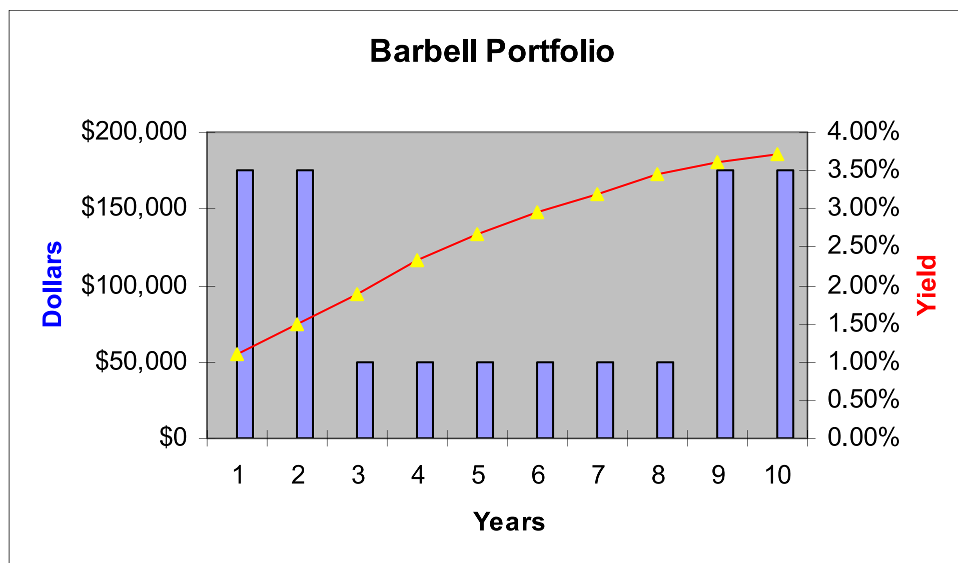



at the end of the ladder (10th year for a 10-year ladder). It becomes a perpetual ladder.

The actually length (years) of the ladder can obviously vary, with many ranging around 10 years. The ability to customize the maturity length allows the investor to match the investment horizon with the investment' duration. As always, when constructing any portfolio, all investments should be within acceptable risk tolerance levels. This ability to customize allows investors to match maturities with future cash flow needs.

Laddering bonds allows an investor to balance the risk and return in a bond portfolio, thus reducing interest rate risk. Shorter-term bonds carry a higher degree of stability, while the longer-term bonds enhance the overall yield. If we enter a rising interest rate environment, with a normal yield curve, as each rung matures, any new bonds being added are done so at a higher rate, increasing the portfolios yield. If rates continue to decrease (at least they can't go below zero!), the remaining bond yields will be higher than those available in the current marketplace. A bond ladder also has the added benefit of providing predictable income. The life of the ladder is approximately half the longest maturity.

The barbell strategy differs from a ladder in that, the barbell is more heavily weighted on the short and long ends of the yield curve, with intermediate maturities underweighted, whereas the ladder is evenly dispersed along the yield curve. By utilizing heavier weightings on the short and long end of the curve, the portfolio takes on the volatility characteristics of an intermediate bond portfolio. The long end allows you to lock in higher yields, while the short end allows you to take advantage of changes in the marketplace.




Managing a barbell portfolio can be more complicated than a laddered portfolio. Each year, the investor must replace two bond maturities in the portfolio. Adjustments need to be made to both the short and long end of the yield curve for the portfolio. This increases the number of transactions needed to keep the barbell strategy in tact. One consequence of making changes to both ends of the barbell is an increase in trading, which will lead to a higher overall expense ratio for the strategy, which needs to be taken into consideration.

In either strategy, an investor may also use a variety of bond types at each maturity interval - corporate, treasury, and mortgage backed bonds, are just a few of the choices. This will allow investors to leverage the yield spreads that exist between the varying quality of bonds, and increase the overall yield of the portfolio. Investors should be

aware that the size of a portfolio can make a difference in the price paid for bonds. A typical round lot of bonds is $100,000 par value. Often times, when purchasing amounts under this size, spreads between the bid and ask prices increase, lowering the portfolios yield. Investors can benefit from the use of a money manager, who typically receives more competitive institutional pricing on bond transactions.

When considering one strategy over another, investors need to have a good understanding of not only what their cash flow needs are, but also what the yield curve will look like over time, any time horizon constraints and risk tolerance levels. The direction of the curve can affect either strategy differently. A key benefit of either strategy is to increase the overall cash flow made available to the investor, while reserving the ability to take advantage of interest rates as they move higher. For the average portfolio, the laddering concept is an easier way to go. It takes the guesswork out of interest rates, is less complicated, and may exhibit an overall lower expense ratio.

**Professional Background**
Mr. Coughlan is a Portfolio Manager with Stellar Capital Management, LLC, a boutique money management firm specializing in high-net-worth and institutional clients. His credentials include over nine years of investment experience with major banks and accounting/consulting firms. Mr. Coughlan has an MBA and MS in Information Management from a top ranked business school and a Bachelors degree in Finance. Mr. Coughlan is an adjunct professor in finance at Keller Graduate School of Management.

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