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Is Now the Time for Bonds?

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While bonds might not have the sizzle of a high-flying, trendy growth stock, bonds play an important part of a sound investment portfolio and represent a different asset class that most long-term investors should consider.

Like the stock market, the bond market is heavily influenced by global economic and political trends. It may surprise you that the world bond market is considerably larger and more influential than the stock market, and much of the world economy depends on international bond trading. This month, we'll scratch the surface and look at a few bond-basics.

What are bonds?

Bonds are essentially a manner in which you lend money to a company, municipality, or the government under an agreement that the money will be paid back at a set date in the future. In exchange for your lending them the money, the borrower (the bond issuer) agrees to pay you a rate of interest. Bonds are sold in varying increments, and maturities (repayment dates) range from under one year to as long as 20-30 years. Bonds can be purchased as individual securities or as a diversified portfolio by investing in a bond mutual fund, exchange traded fund or unit investment trust. Choosing the right way to invest depends on your specific time horizon, risk preference, and the amount you have to invest.

What are the benefits?

Adding bonds to a portfolio has typically been considered a conservative move and a good idea for those with a lower tolerance for risk, but there are many reasons why bond investments are of benefit.

Since bonds inherently have a different risk and return character than stocks, they often behave differently when the markets move. During volatile periods in the stock market or

through extended stock market corrections, bonds can provide a buffer and stability.

Another noteworthy benefit for savvy investors, keeping an eye on their tax bracket, is that certain bonds offer some very special tax advantages. For instance, there is no state or local income tax on the interest from U.S. Treasury bonds. There is no federal tax on the interest from most municipal bonds, and in some places, no state or local income tax, either. Consider utilizing a financial advisor to help determine which bonds are best for you.

On the other side of the equation, investors may want to consider taxable bonds inside of tax-sheltered retirement plans including IRAs and self-directed 401(k) plans. Not only do they create an attractive compliment to growth-oriented and dividend-paying stocks, the scheduled stream of bond interest payments can help with current distribution needs or to provide future retirement income.

What are the risks?

The most basic risk of bond investing is that an issuer may default. That is, the issuer doesn't have the ability to make the interest payments or to repay the principal at maturity. Investors may reduce their default risk by investing in U.S. government bonds, insured municipal bonds, or bonds backed by the taxing authority of a municipality. Many corporate bonds and municipal bonds are rated by third-party financial analysts to provide investors with an idea of the financial soundness of the issuer. Bonds ratings may change over time so it's important to monitor individual bonds that you may own.

Unlike stocks, bonds are designed to return the original investment, or principal, to the investor at a future maturity date. This preservation of capital adds stability to a portfolio and balances the growth and risk aspect of stocks. It's important to note that you can still lose money if you sell your bonds before

maturity at a price lower than your purchase price, or in the event that the borrower defaults, but by choosing high-credit-quality bonds, you can limit your exposure to default risk.

Since the interest rate you receive when purchasing a bond is generally locked-in when you purchase it, the value of a bond fluctuates as interest rates move. In short, bond prices will react the opposite way to interest rates. Lower interest rates mean higher bond prices, and higher interest rates mean lower bond prices. If you own a bond with a fixed interest rate and plan to hold it to maturity, you don't have to worry about the changes in interest rates, unless you have to sell the bond unexpectedly.

Are bonds right for me?

For many investors, a combination of stocks and bonds is the best choice. By diversifying your investments and putting some money into both stocks and bonds, you may reduce your risk while leaving the opportunity for higher rewards from your stock investments. While you'll usually get a lower return in exchange for the reduction in risk level, there have been times (as recent as the stock market correction from 2000-2003) when bonds have outperformed stocks. Whether you're young or old, conservative or growth-oriented, still accumulating or in need of income, investors at all life stages have financial planning needs that stand to benefit from bonds.

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