

June 2008 Issue

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Varying Your Bond Strategies

A common misconception regarding bonds is that they are only appropriate for older or more conservative investors. However, bonds should be considered by all investors as part of a well-diversified portfolio, even though their role may change over your lifetime.

Your 20s and 30s

At this stage in your life, your investment goal is probably to maximize your capital. Your time horizon is very long, and your risk tolerance is probably high. Often, stocks will comprise a significant portion of your portfolio, but you should also consider bonds to diversify your portfolio and balance risk and volatility. Since your risk tolerance is high, you might consider higher-risk bonds, such as high-yield bonds. If your investments in your employer's 401(k) plan or other retirement plan are heavily weighted in stocks, you might want to increase your bond allocation in your taxable portfolio.

No matter how you decide to invest, now is a great time to get in the habit of investing regularly by starting a dollar cost averaging program. Dollar cost averaging involves investing a set amount of money in the same investment on a periodic basis. For instance, instead of investing a lump sum in one stock immediately, you might invest \$2,000 in that stock at the beginning of each

month. A dollar cost averaging program is by definition a long-term program. Thus, if followed consistently, it helps encourage long-term investing. Dollar cost averaging, however, does not ensure a profit or protect against loss in declining markets. Before starting a dollar cost averaging program, consider your financial ability to continue purchases through periods of low price levels.

Your 30s and 40s

Your investment goal at this point in your life is probably to grow your capital. Your investment time horizon is still long, but your risk tolerance may be more moderate. During these years, you'll typically accumulate a significant portion of your retirement portfolio. As your children's college educations and your own retirement get closer, you will probably feel less comfortable with the possibility that your investment portfolio could decline substantially, which is why your risk tolerance is moderate. At this point, you may want to shift more of your investment portfolio to bonds. You may want to consider zero-coupon bonds, with maturities that coincide with your children's college educations. If you find yourself in a high tax bracket, you might want to take a look at municipal bonds, since the interest income is exempt from federal, and sometimes state and local, income taxes.

Your 50s and 60s

Now, your investment goal is probably to conserve capital. Your investment time horizon is moderate, while your risk tolerance is lower. With retirement getting close, you don't want to risk a major decline in your investment portfolio, so your risk tolerance is low. Bonds will probably take on increasing importance in your portfolio at this stage of life. You'll want to make sure you have a well-diversified portfolio of bonds, probably setting up a bond ladder to manage interest rate risk. Municipal bonds will probably still be of interest if you remain in a high tax bracket.

Investing after retirement

At retirement, your primary investment goal is to preserve your capital. Your investment time horizon will depend on when you will use your investments, but your risk tolerance is probably low. Many retirees like to use the steady income from bonds as a source of regular retirement income. Inflation is also a concern, so you may want to consider Treasury Inflation Protection Securities (TIPS).

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Using Bond Swaps

A passive approach to bond investing typically involves purchasing a bond and holding it to maturity. With that approach, you receive your entire bond principal and do not have to worry about the effects of interest rate changes on the price of your bond. However, as the interest rate environment changes, there may be opportunities to use more active strategies for your bond investments, such as bond swaps.

A bond swap is simply the sale of one bond and the purchase of another, designed to better meet your investment objectives or to take advantage of current market or tax conditions. Some of the more common swaps include:

- A **rate anticipation swap** is made to take advantage of changes in market interest rates. It typically involves swapping short- for long-term bonds or vice versa, depending on your beliefs about the future direction of interest rates. If you anticipate interest rates will increase, you might swap out of longer-term bonds into shorter-term bonds. Then, when interest rates increase, your bonds won't be significantly affected by the rate change, and you will have funds available to invest at higher rates. If you anticipate lower interest rates, you would do the opposite to lock in current rates.
- A **substitution swap** involves swapping one bond for another similar bond with higher yields. That could happen if a company's financial situation has improved, but the bond's credit rating hasn't been upgraded yet.
- An **intermarket swap** involves swapping bonds in different market sectors, such as government and corporate, to take advantage of changing yield spreads. For instance, the spread between corporate and municipal bonds may narrow, making the returns on municipal bonds higher than corporate bonds on a tax-equivalent basis.
- A **tax swap** is made to realize a bond's loss for tax purposes. You sell bonds with a current market value less than your purchase price so you can realize the loss and deduct it on your tax return. You then use the proceeds to purchase a similar bond. The end result is you own a comparable bond, but you also have a tax loss to deduct on your tax return. That loss can be used to offset other capital gains or to offset up to \$3,000 of ordinary income in excess of gains, with any excess losses carried forward to future years.

When making a tax swap, you must comply with the wash sale rules. A wash sale occurs when an investor sells a security at a loss and 30 days before or

after the sale purchases a substantially identical security. If deemed a wash sale, the loss can be deducted for tax purposes. If you want to purchase another bond within the 30-day window, the new bonds must differ in a material way from the bond sold, such as different issuers, coupon rates, or maturity dates.

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Start Budgeting

Almost no one enjoys the process of analyzing and budgeting expenditures, but inefficient and wasted expenditures can be major impediments to accomplishing your financial goals. It is difficult to manage your money if you don't know how much you have or where it is going. Consider these steps when developing your budget:

1. Identify how you are spending your income. Review an annual period so you determine regular monthly expenses as well as irregular, periodic expenses, such as insurance premiums, tuition, and gifts. Much of the information can be found by examining canceled checks, credit card receipts, and tax returns. Total expenses in categories that make sense for your lifestyle. If you can't account for more than 5% of your income, take a closer look at your cash purchases. Keep a journal tracking every penny you spend for at least a month.

2. Evaluate your expenditures. If you find it tough to find money to save, critically review your expenditures. Consider these tips:

- Find ways to save at least 10% of your income. Almost all expenditure categories offer potential for savings. With essential expenses with fixed amounts, such as your mortgage, taxes, and insurance, you may be able to refinance your mortgage, find strategies to help reduce taxes, or comparison shop your insurance to reduce premiums. Essential expenses that vary in amount, such as food, medical care, and utilities, can usually be reduced by altering your spending or living habits. For instance, you can actively shop for food with coupons, exercise to get in better health, or put energy saving light bulbs through your house. Discretionary expenses, such as entertainment, dining out, clothing, travel, and charitable contributions, typically offer the most potential for spending reductions. Dining out four times a week? Reduce it to two, go to less expensive restaurants, and save the difference.
- Limit the use of your credit cards, especially if you're not paying the balance in full every month. Not only do credit card balances carry high

interest charges, but credit cards tend to encourage impulse spending. Use cash or a debit card, which automatically deducts purchases from your bank account.

- Resolve not to purchase impulse items or items over a certain dollar amount on your first shopping trip. Go home, think about it for a couple days, and then go back to purchase the item. Often, you'll decide you don't really need it.
- Delay the purchase of large items. For example, instead of purchasing a new car every two or three years, keep your car for four or five years.
- If you're really serious about reducing expenses, consider moving to a less expensive house. Not only will you reduce your mortgage payment, but you will save on other costs, such as property taxes, insurance, and utilities.

3. Prepare a budget to guide future spending. You may want to start by setting a budget for a couple months, tracking your expenses closely over that time period. You can then fine tune your budget for an annual period. Some tips to consider when preparing your budget include:

- Don't include income in your budget that is uncertain, such as year-end bonuses, tax refunds, or gains on investments. When you receive that money, just put it aside for saving.
- Set up enough expenditure categories to give you a good feel for your spending patterns, but not so many that it becomes difficult and time consuming to monitor your progress.
- Make your budget flexible enough to handle unforeseen expenditures. Nothing goes exactly as planned, and your budget should be able to deal with emergencies. Be sure to include large, periodic expenditures, such as insurance premiums or tuition.
- Don't be so rigid that your family is afraid to spend any money. Everyone in the family should have a reasonable allowance that can be spent without accounting for it.
- Find ways to make the savings component of your budget happen automatically. Get the money out of your bank account and into an investment account before you have a chance to spend it.

The money you have available for saving is a direct result of your spending habits. Use a budget to control your spending so you can maximize your savings.

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Stretching Your IRA

Individual retirement accounts (IRAs) are usually viewed as retirement planning vehicles. But with increased contribution amounts and the ability to roll over 401(k) balances to an IRA, many IRA owners are finding they won't use the entire IRA balance for retirement. Thus, IRAs are increasingly becoming major estate planning tools. When used for estate planning, the goal is to extend the IRA's life as long as possible so that beneficiaries can benefit from the tax-deferred (for traditional IRAs) or tax-free (for Roth IRAs) growth. How can you accomplish that?

Assume you have a large traditional IRA balance, which includes a rollover from your 401(k) plan. You don't have to start taking distributions until age 70 1/2. Then, you only take required minimum distributions calculated based on your life expectancy. When you die, you leave the IRA to your spouse, who rolls the balance over to his/her own IRA and names his/her own beneficiaries, perhaps your children or grandchildren. Your spouse delays distributions until age 70 1/2 and then only takes required distributions. When your spouse dies, your children inherit the IRA, which can be divided into separate IRAs for each child. Each child can then take distributions based on each of their life expectancies and can name their own beneficiaries. When your children die, their beneficiaries cannot reset the distributions based on their life expectancy, but the beneficiaries can continue to take distributions based on the previous owner's schedule until the IRA is depleted. By using this strategy and only taking minimum distributions when required, the balance can continue to grow on a tax-deferred basis for years or even decades.

The concept can be expanded further by converting a traditional IRA to a Roth IRA. Although income taxes will have to be paid on any amounts that would have been taxable when withdrawn (contributions and earnings in a deductible IRA and earnings in a nondeductible IRA), the income taxes can be paid with funds outside the IRA, leaving the IRA balance intact. While your adjusted gross income must be less than \$100,000 (not counting the rollover) to convert, this requirement will be eliminated in 2010, allowing all taxpayers to convert from a traditional to a Roth IRA. Once the funds are in the Roth IRA, you do not have to take any withdrawals during your life. Since your spouse can roll the balance over to his/her own IRA, he/she would also not have to take withdrawals during his/her lifetime. When your spouse dies, his/her beneficiaries would then have to take distributions over their life expectancies, but qualified distributions would be taken free of federal income taxes.

Don't lose sight of the fact that your IRA's main purpose is to fund your retirement. It should only be used for estate planning purposes if you don't need the funds for retirement.

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Protecting against Inflation with TIPS

Treasury Inflation Protected Securities (TIPS) were created in 1997 to provide bond investors with inflation protection by periodically adjusting the bond's face value based on the increase in the Consumer Price Index for All Urban Consumers (CPI-U). The bond's interest rate is determined at auction and does not change during the bond's life, but the principal is adjusted every six months. Thus, subsequent interest payments are based on the increased principal amount.

If the CPI-U decreases, your principal will decrease, so that your interest payments will also decrease over time. However, when the bond matures, you still receive the full principal value.

From a tax standpoint, interest income is subject to federal income taxes, but not state or local income taxes. Also, any increases in the bond's principal value is subject to federal income taxes in the year the adjustment is made, even though the funds aren't received until the bond matures. However, if the TIPS is held in a tax-advantaged account, such as a 401(k) plan or individual retirement account, income taxes are not paid until the funds are withdrawn.

To decide whether TIPS are a better alternative than other Treasury securities, calculate the difference between the yield on a 10-year TIPS and a 10-year Treasury security. As of May 27, 2008, that difference was 2.49% (Source: *Federal Reserve Statistical Release*), which is considered the breakeven rate. If inflation is higher than 2.49% over the 10-year period, the TIPS will have a higher yield than other Treasury securities. However, if inflation is lower than 2.49%

over the 10-year period, the other Treasury security will have a higher yield than the TIPS.

With current inflation rates running around 3.8%, you might think that a TIPS is the better alternative. However, it is difficult to predict inflation over long time periods, so future inflation could be lower.

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