“It’s **Your** Money”

Fixed Income Investing

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What is “fixed income”?

- It’s a LOAN
- You’re giving money to someone for some period of time hoping to be paid back and receive more than you started
- Most commonly you are loaning money and receiving interest until your principal is returned

Fixed Income Examples

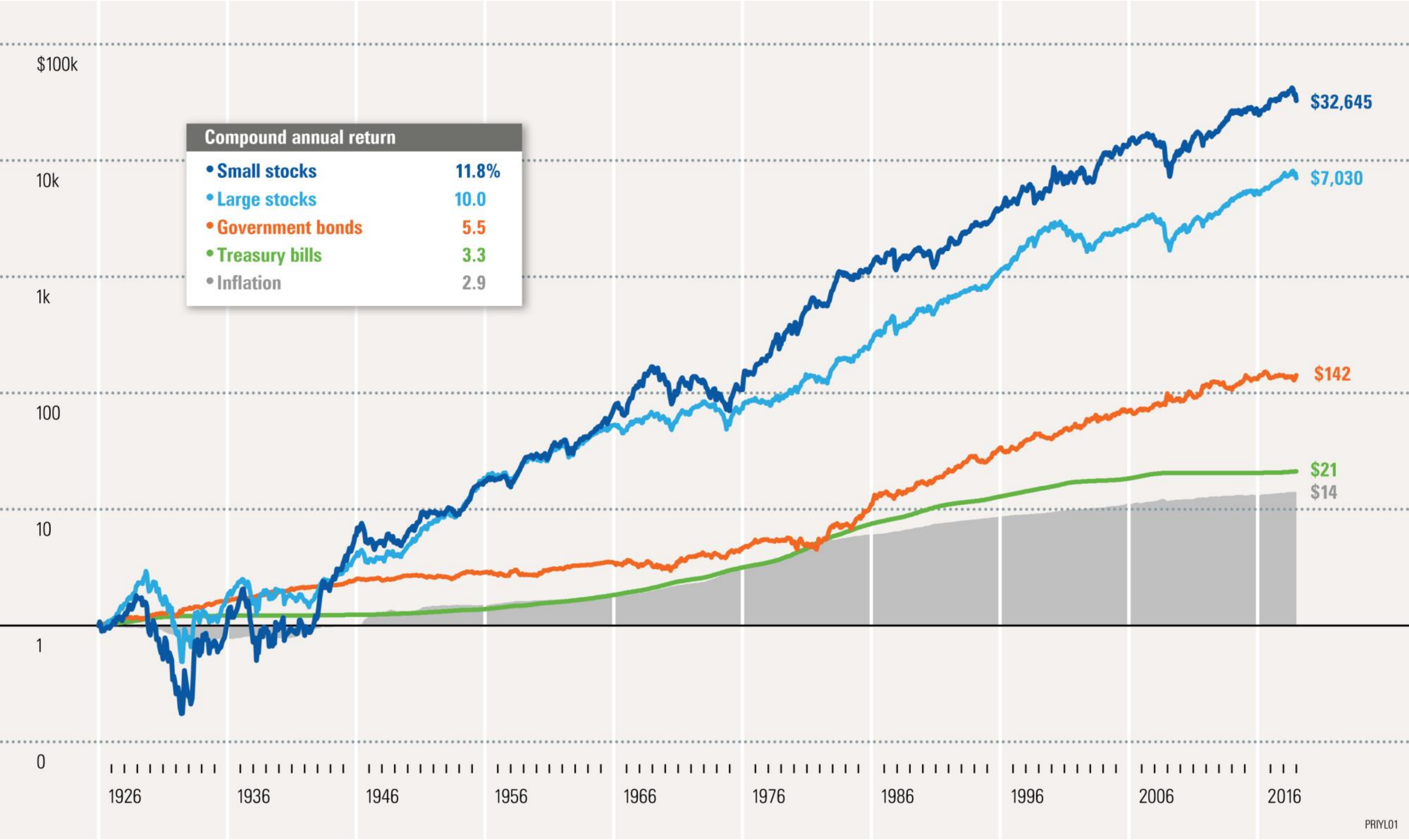
- CDs (Certificates of Deposit)
- US Treasuries
- Municipal (“Muni”) Bonds
- Corporate Bonds
- Mortgage Backed Bonds
- International Bonds

Benefits of Fixed Income

- Dependable income
  - Periodic payments
    - Most are semi-annual
    - Can be monthly, annually, none (“zero coupon”)
  - Higher yield than cash and inflation
    - Averaging 2.5% to 3% above inflation rate
    - Long-term returns have averaged 5.5% to 6%
- Complement to other investments
  - Provide downside protection
  - Typically act counter-cyclically to stocks

Ibbotson® SBBI®

Stocks, bonds, bills, and inflation 1926–2018



Risk Determines Expected Return

- Credit (“default”) risk - *Will I get paid?*
- Inflation risk – *Will my bond return keep up with inflation?*
- Interest rate (“price”) risk – *Will interest rate moves reduce the price of my bond?*
- Re-investment risk – *Will I be reinvesting at lower interest rates?*
- Other risks: liquidity risk, currency risk, downgrade risk

Risk Determines Expected Return

- Examples:
  - 1-Year CD has no default risk; little inflation risk; no interest rate risk; little reinvestment risk so the expected return will be quite low (1.5% to 2%)
  - 10-year Treasury Note has no default risk; some inflation risk; some interest rate risk; some reinvestment risk so the expected return will be relatively low (3% to 3.5%)

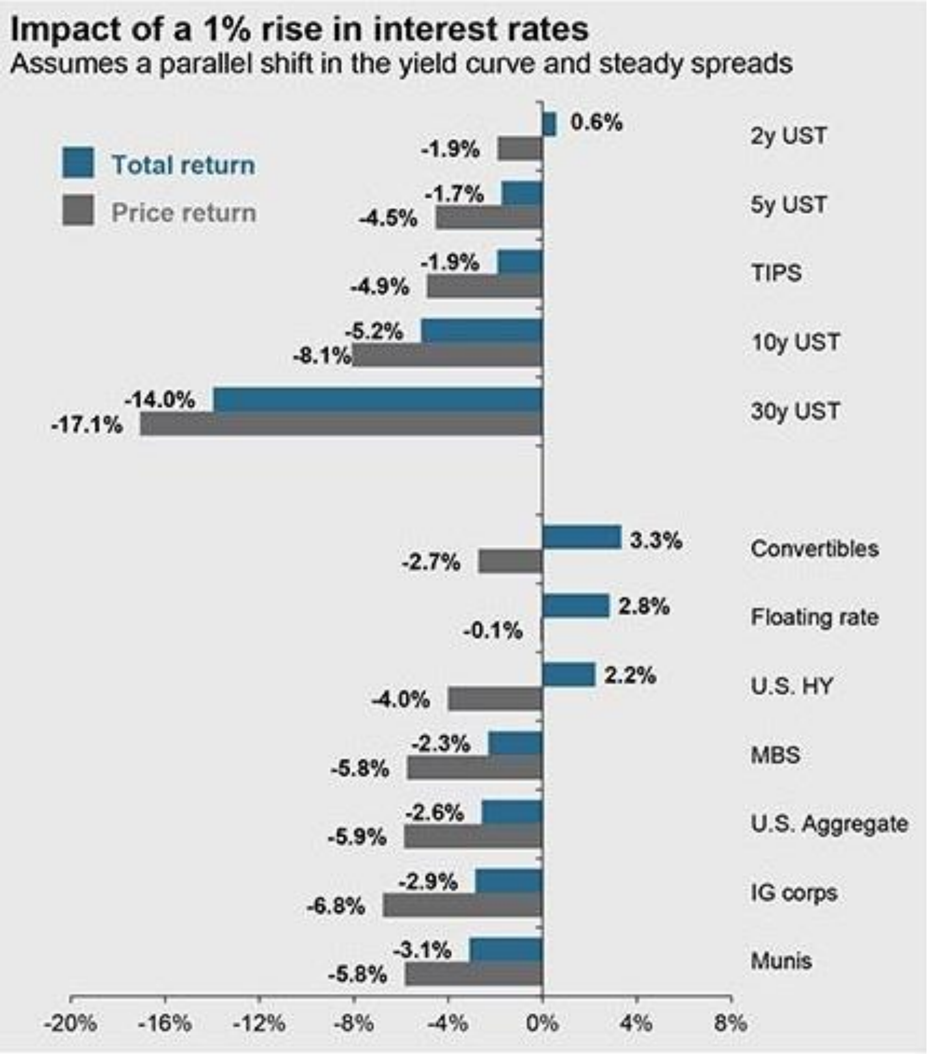
Risk Determines Expected Return

- Examples:
  - 10-year Citigroup bond has little default risk; some inflation risk; some interest rate risk; some reinvestment risk so the expected return will be low (4% to 5.5%)
  - 5-year unsecured loan to my brother has lots of default risk; some inflation risk; some interest rate risk; some reinvestment risk so the expected return should be high (12% to 18%)

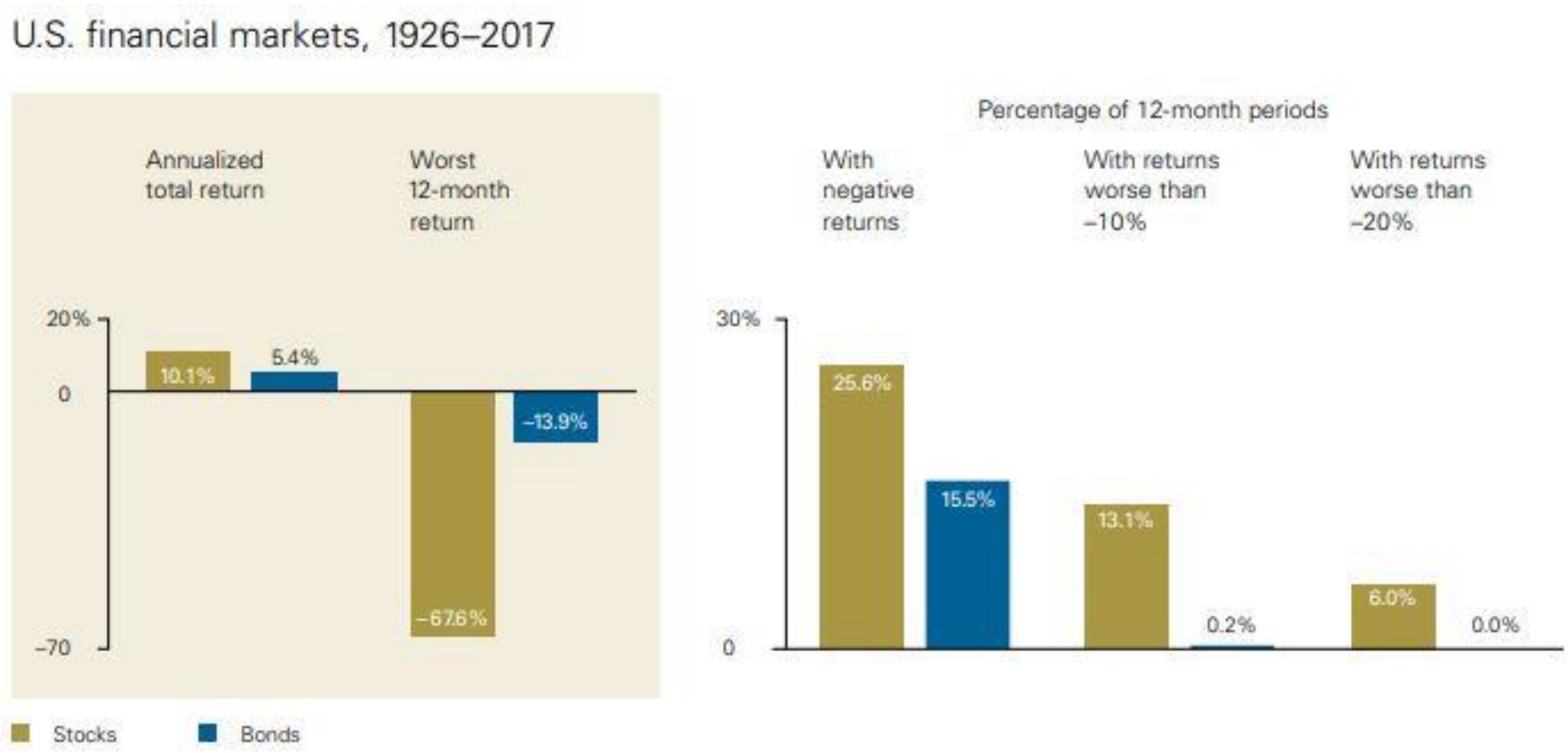
Interest Rates and Price Move In Opposite Directions

- When interest rates rise, bond prices fall
- When interest rates fall, bond prices rise

Bonds Can Go Down In Value



Bonds Are Safer Than Stocks



Be Wary of Bond "Alternatives"

- Investors have moved to bond alternatives, but these often add substantial risk to an investment portfolio

Asset Class	2008 Return
Total Bond Market	+5%
Dividend Paying Stocks	-23%
High Yield Bonds	-26%
Master Limited Partnerships	-37%
Real Estate Investment Trusts	-38%
Commodities	-48%

Bonds Are Diverse

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	YTD	Ann.
EMD LCL. 23.0%	EMD USD 10.2%	EMD LCL. 15.2%	EMD LCL. 18.1%	Treas. 13.7%	High Yield 58.2%	EMD LCL. 15.7%	TIPS 13.6%	EMD USD 17.4%	High Yield 7.4%	Muni 8.7%	Muni 3.8%	High Yield 17.1%	EMD LCL. 15.2%	Muni 1.4%	Corp. 13.2%	EMD USD 7.0%
EMD USD 11.6%	EMD LCL. 6.3%	High Yield 11.8%	TIPS 11.6%	MBS 8.3%	EMD USD 29.8%	High Yield 15.1%	Muni 12.3%	EMD LCL. 16.8%	MBS -1.4%	Corp. 7.5%	MBS 1.5%	EMD USD 10.2%	EMD USD 10.3%	MBS 1.0%	EMD USD 13.0%	High Yield 7.0%
High Yield 11.1%	Asset Alloc. 3.1%	EMD USD 9.9%	Treas. 9.0%	Barclays Agg 5.2%	EMD LCL. 22.0%	EMD USD 12.2%	Treas. 9.8%	High Yield 15.8%	Corp. -1.5%	EMD USD 7.4%	EMD USD 1.2%	EMD LCL. 9.9%	High Yield 7.5%	Treas. 0.9%	High Yield 11.4%	EMD LCL. 5.9%
TIPS 8.5%	TIPS 2.8%	Asset Alloc. 5.7%	Barclays Agg 7.0%	Muni 1.5%	Corp. 18.7%	Corp. 9.0%	Corp. 8.1%	Corp. 9.8%	Asset Alloc. -1.9%	MBS 6.1%	Treas. 0.8%	Corp. 6.1%	Corp. 6.4%	Barclays Agg 0.0%	Asset Alloc. 8.9%	Asset Alloc. 4.8%
Asset Alloc. 6.6%	Treas. 2.8%	MBS 5.2%	MBS 6.9%	Asset Alloc. 0.1%	Asset Alloc. 14.7%	Asset Alloc. 7.9%	Asset Alloc. 8.1%	Asset Alloc. 7.4%	Barclays Agg -2.0%	Barclays Agg 6.0%	Barclays Agg 0.5%	Asset Alloc. 4.7%	Muni 5.8%	Asset Alloc. -0.7%	Barclays Agg 8.5%	Corp. 4.6%
Corp. 5.4%	Muni 2.7%	Muni 4.7%	Asset Alloc. 6.7%	TIPS -2.4%	TIPS 11.4%	Barclays Agg 6.5%	Barclays Agg 7.8%	TIPS 7.0%	Muni -2.2%	Asset Alloc. 5.5%	Asset Alloc. -0.3%	TIPS 4.7%	Asset Alloc. 5.3%	TIPS -1.3%	EMD LCL. 7.9%	Muni 4.4%
MBS 4.7%	High Yield 2.7%	Barclays Agg 4.3%	EMD USD 6.2%	Corp. -4.9%	Muni 9.9%	TIPS 6.3%	EMD USD 7.3%	Muni 5.7%	Treas. -2.7%	Treas. 5.1%	Corp. -0.7%	Barclays Agg 2.6%	Barclays Agg 3.5%	High Yield -2.1%	Treas. 7.7%	MBS 3.9%
Barclays Agg 4.3%	MBS 2.6%	Corp. 4.3%	Corp. 4.6%	EMD LCL. -5.2%	Barclays Agg 5.9%	Treas. 5.9%	MBS 6.2%	Barclays Agg 4.2%	EMD USD -5.3%	TIPS 3.6%	TIPS -1.4%	MBS 1.7%	TIPS 3.0%	Corp. -2.5%	TIPS 7.6%	Barclays Agg 3.9%
Muni 4.1%	Barclays Agg 2.4%	Treas. 3.1%	Muni 4.3%	EMD USD -12.0%	MBS 5.9%	MBS 5.4%	High Yield 5.0%	MBS 2.6%	TIPS -8.6%	High Yield 2.5%	High Yield -4.5%	Treas. 1.0%	MBS 2.5%	EMD USD -4.3%	Muni 6.9%	TIPS 3.8%
Treas. 3.5%	Corp. 1.7%	TIPS 0.4%	High Yield 1.9%	High Yield -26.2%	Treas. -3.6%	Muni 4.0%	EMD LCL. -1.8%	Treas. 2.0%	EMD LCL. -9.0%	EMD LCL. -5.7%	EMD LCL. -14.9%	Muni -0.1%	Treas. 2.3%	EMD LCL. -6.2%	MBS 5.6%	Treas. 3.5%

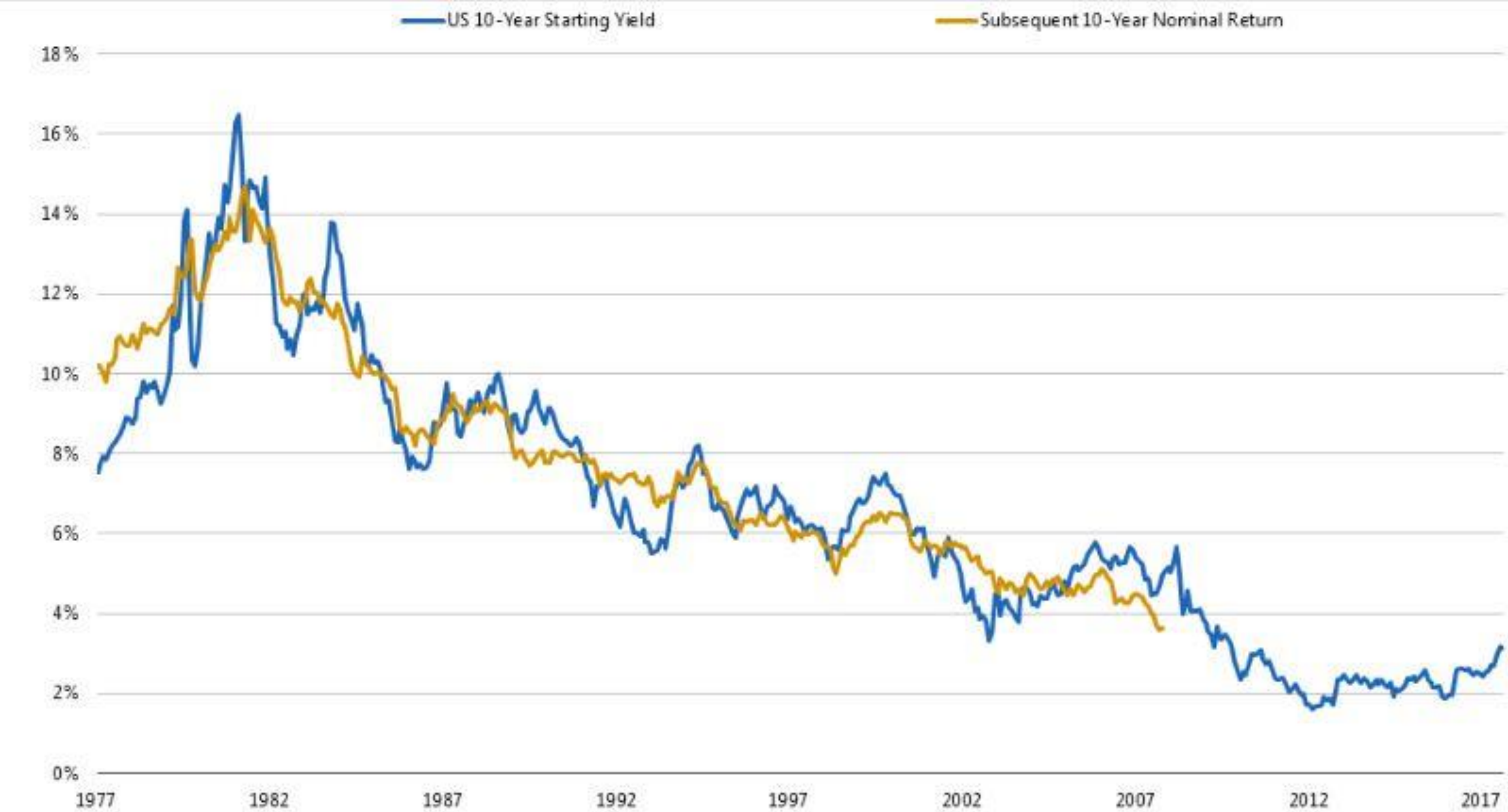
Bond Interest Rate Tells You Little About Total Return

- Many individual bonds are not purchased “at par” (at their origination)
- Price of bond matters to determine total return

- For example:
  - 10-Year Bond With 5% Coupon Purchased at 100 (Par) will have a total return of 5% over its life
  - If purchased at 110, total return drops to 3.8%
  - If purchased at 90, total return increases to 6.4%

- “Yield to maturity” and “yield to call” are better measures

Bond Returns Are Predictable – They’ll Be Low Going Forward



As of 30 March 2018. SOURCE: Bloomberg. 10-Year Yields based on Barclays US Agg Total Return Value Unhedged USD.
Past performance is not a guarantee or a reliable indicator of future results. It is not possible to invest directly in an unmanaged index.

PIMCO

U.S. Core Bonds: Starting Yield vs. Subsequent 10-Yr Returns

Municipal Bonds?

- “Munis” are typically called tax-free bonds, interest on these bonds can be:
  - Free from federal taxes
  - Free from state taxes
  - Free from both federal and state taxes
- Interest rates for these bonds is typically lower, but the “after-tax” rate can be higher than taxable bonds
- Example: Scott owns a federal and state exempt municipal bond paying 5%.
  - If Scott is in the 12% combined tax brackets, he would have to own a taxable bond paying 5.6% to be ahead.
  - If Scott is in the 47% combined tax brackets, he would have to own a taxable bond paying 9.4% to be ahead.

Buying Individual Bonds

- No central exchange
- Bonds are generally bought and sold through brokerage firms
- Quotes can vary significantly from broker to broker
- No transparency (commissions are built into the bond pricing)

Buying Individual Bonds

- Advantages:
  - Can be held to maturity
  - Can be “laddered” to match cashflow needs
- Disadvantages:
  - Difficult to diversify
  - Expensive to buy/sell
  - Research is necessary

Buying Bond Mutual Funds

- Bond funds come in all types:
  - Different maturity ranges:
    - ultra-short
    - short-term
    - intermediate-term
    - long-term
  - Different sectors:
    - "Total Return"
    - Government
    - Corporate
    - High yield
    - Inflation protected
    - Municipal
    - International
    - Emerging market

Buying Bond Mutual Funds

- Advantages:
  - Well diversified
  - Professionally managed
  - Easy to buy and sell – fair pricing

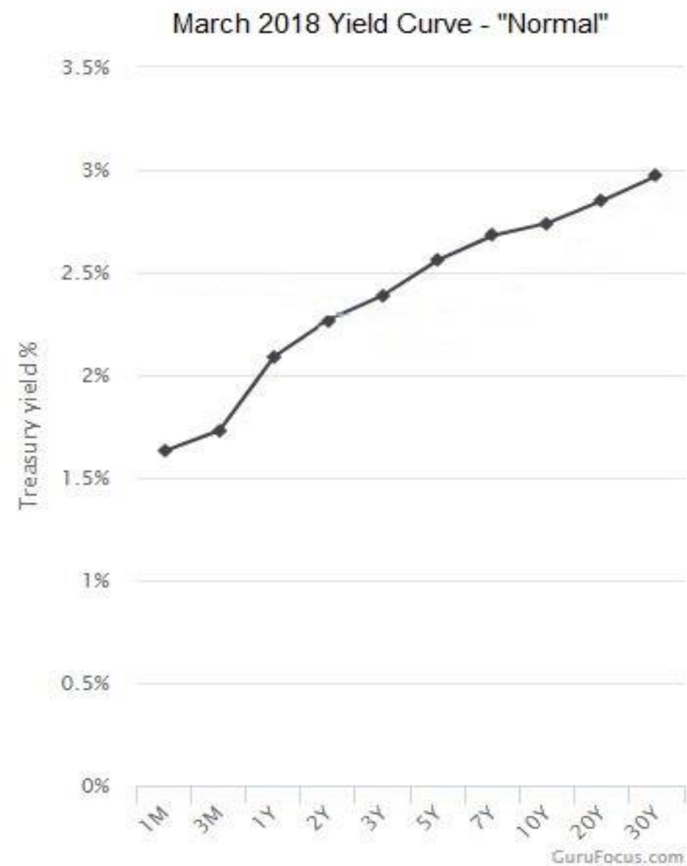
- Disadvantages
  - No fixed yield or maturity date – less certainty of outcome
  - Less control of investments
  - FEES: (0.2% to 1.5%)

Buying Bond Mutual Funds

- Using bond mutual funds is the better choice for most investors
- Understand maturity/term and sectors owned
- Current yield and recent performance are not good indicators of future performance
- Watch fees! Lower fee funds outperform higher fee funds

Yield Curves – Normal Yield Curve

- In most environments, short-term bond yields are lower than long-term bond yields
- This makes sense since longer-term bonds carry more risk for which investors need to be compensated

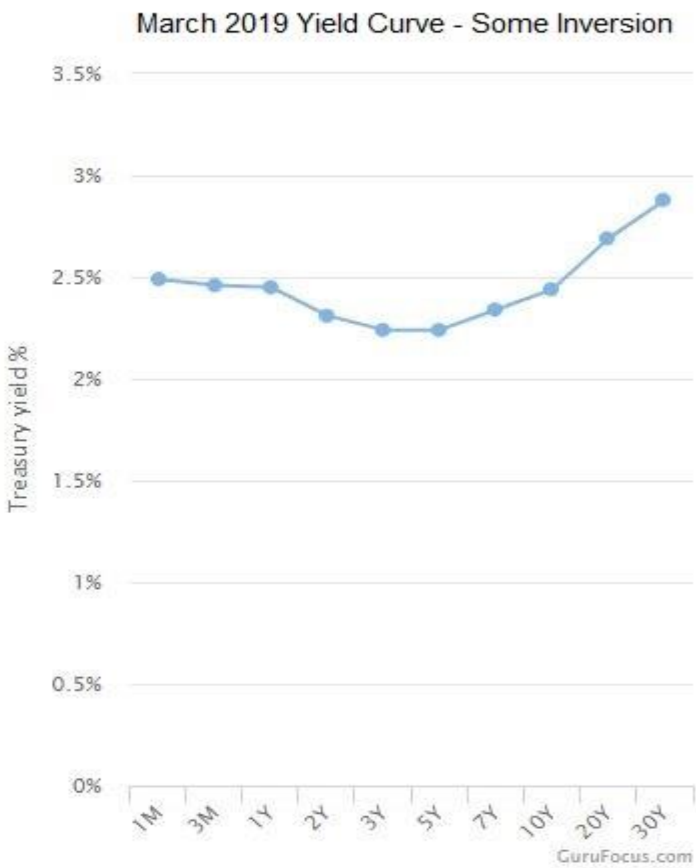


Yield Curves – Inverted Curve

- There are times when short-term bonds actually yield more than long-term bonds – this is called a yield curve inversion

- These times are interesting because they show that the bond markets are pessimistic about the future of the economy

- “Inversions” have been a good predictor of future recessions



When Recessions Happen

- Performance of the stock market before, in and after recessions aren't *too* scary

	1 Year Prior	Recession	+1 Year	+3 Years	+5 Years
Aug 1957 - Apr 1958	0.8%	-6.4%	37.2%	66.1%	89.3%
Apr 1960 - Feb 1961	3.1%	18.3%	13.5%	34.8%	67.7%
Dec 1969 - Nov 1970	-10.7%	-3.4%	11.3%	20.4%	24.8%
Nov 1973 - Mar 1975	-0.1%	-18.2%	28.3%	21.6%	54.8%
Jan 1980 - July 1980	18.5%	16.4%	13.0%	56.0%	100.0%
July 1981 - Nov 1982	20.7%	14.4%	25.5%	66.4%	102.4%
July 1990 - Mar 1991	16.5%	7.6%	11.1%	29.9%	98.3%
Mar 2001-Nov 2001	-8.2%	-7.2%	-16.5%	8.4%	34.2%
Dec 2007-June 2009	7.7%	-35.5%	14.4%	57.7%	136.9%
Averages	**5.4%**	**-1.5%**	**15.3%**	**40.1%**	**78.7%**

Source: awealthofcommonsense.com