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Diversify Your Bond Portfolio

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Most investors can best buy the bond portion of their portfolios by purchasing bond mutual funds. Because the best prices on bonds are usually in very large increments (think $1,000,000 per purchase), individuals benefit from being able to participate in a pool of professionally managed funds invested in the bond market. (For information on individual bonds, see Strategy #27.) Your approach to diversifying your bond portfolio depends upon whether you're in the accumulation phase or the retirement phase of your life.

TIP

Bond fund returns are especially sensitive to the fees of mutual funds because they typically don't see the high returns of stock funds. Keep an eye out for expense ratios of less than 0.30 percent.

Advice for Early- and Mid-Life Accumulators

Early- and mid-life accumulators can benefit from exposure to all parts of the bond market. Because of their long time horizon, they don't have to be as defensive against hard times in the investment cycle. An early accumulator should invest bond money as follows:

- **Short-term bond fund:** 35 percent
- **Intermediate-term bond fund:** 35 percent
- **Inflation-protected securities:** 20 percent
- **High-yield bonds:** 10 percent

Different sources define short-, intermediate-, and long-term differently. But generally, *short-term* bonds have maturity dates of five years or less, *intermediate-term* bonds have maturities of five to ten years, and *long-term* bonds have stated maturities that are longer than ten years. *Inflation-protected securities* are a relatively new type of security and are generally called TIPS

(Treasury Inflation Protected Securities — see Strategy #18). *High-yield bonds* are usually less creditworthy, which means they have to pay a higher rate to attract investors. These investments are riskier, but they can be appropriate for accumulators because the long-term horizons can temper the risk.

In this section, you discover how to allocate your bond investment if you have ten or more years until retirement.

Let returns and volatility direct allocation

Standard deviation is one way of measuring the volatility of bonds and other securities. A standard deviation of 4 percent means that historically, the actual returns of a given security class have ranged from 4 percent below the category average to 4 percent higher. The lower the standard deviation, the lower the volatility and therefore the lower the market risk.

Table 46-1 shows that shorter-term bonds have lower volatility and that long-term, mortgage, and high-yield bonds have greater volatility. For a long time horizon, an ideal allocation is a blend of short-term bonds, intermediate-term bonds, and in some cases, mortgage bonds.

Table 46-1 Average Bond Returns and Volatility

Bond Category	*Historical Average Return*	*Standard Deviation*
Short term	7.34%	4.14%
Intermediate term	8.24%	6.83%
Long term	8.63%	10.94%
Mortgage	9.49%	10.64%
High yield	8.86%	10.60%

Source: MoneyGuide Pro

REMEMBER

As an individual investor, you don't get enough additional return from purchasing long-term bonds over intermediate-term bonds, given the dramatic rise in volatility for long-term bonds. Long-term bonds are generally better suited for businesses such as insurance companies that need to match the maturities of their assets with their liabilities. High-yield bonds can at times be appropriate in an individual portfolio, but their risk and return profile fits more into a stock allocation than bond allocation.

Set up an ideal allocation among bonds

For most investors, an appropriate bond allocation puts equal amounts of money in short-term and intermediate-term bonds, as Table 46-2 shows.

Table 46-2 Bond Allocation for Early to Mid Life

Allocation	*Historical Return*	*Historical Standard Deviation*
50% short term	7.34%	4.14%
50% intermediate term	8.24%	6.83%
Total bond allocation	7.79%	5.48%

Source: MoneyGuide Pro

TIP

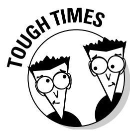
Unless you need to invest in tax-exempt bonds, the short- and intermediate-term bond funds should be invested in Treasuries, agencies, corporate bonds, and mortgages. You want exposure to all parts of the bond market with these funds. (For info on government bonds and Treasuries, see Strategy #18.)

Table 46-3 shows a slightly more aggressive bond allocation that includes mortgage bonds. If mortgage bonds are appropriate for your portfolio given your risk profile, Government National Mortgage Association bonds, or GNMA bonds (sometimes referred to as *Ginnie Maes*), are preferable. *GNMA* is a U.S. federal government agency that issues bonds to fund housing loans. Other government agencies issue bonds, but only GNMA bonds are backed by the full faith and credit of the U.S. federal government. This makes them similar in credit quality to Treasury bonds, although their *coupon* (the amount of interest paid) and maturity structure is different.

Table 46-3 Short, Intermediate, and Mortgage Bond Allocation

Allocation	*Historical Return*	*Historical Standard Deviation*
35% short term	7.34%	4.14%
35% intermediate term	8.24%	6.83%
30% mortgage	9.49%	10.64%
Total bond allocation	8.28%	7.03%

Source: MoneyGuide Pro



If you go aggressive and invest in high-yield bonds, remember that high-yield bonds tend to be the most volatile. When times get rough, hold off allocating more money to these bonds until the storm begins to blow over. It's impossible to know when things may turn around, so don't abandon your high-yield funds completely — just don't add new funds until the crisis of the day is no longer on the front page.

Bond quality

The quality of the bond also affects bond volatility. The higher the bond is rated, the less sensitive it'll be to uncertain economic times. Table 46-4 explains the ratings of two of the largest rating agencies, Standard & Poor's and Moody's.

If you're an accumulator with a higher risk tolerance and a number of years before retirement, some lower-quality bonds may be appropriate. The higher yield and growth opportunities of lower-rated bonds come at the expense of more risk. If you're an investor with a shorter time frame, this risk may be unacceptable, so your mixture of bonds should tend toward the higher-quality side.

Table 46-4 Bond Ratings

Standard & Poor's Rating	*Moody's Rating*	*Meaning*
AAA	Aaa	Lowest risk
AA	Aa	Slight long-term risk
A	A	Possibly vulnerable to changing economic conditions
BBB	Baa	Currently safe but possibly unreliable over the long term
BB	Ba	Somewhat speculative issue that offers moderate security
B	B	At risk of default in the future
CCC	Caa	Clear danger of default
CC	Ca	Highly speculative or may be in default
C	C	Poor prospects for repayment even if currently paying
N/A	D	In default

Source: Forefield Advisor

Advice for Almost-Retirees and Retirees

If you plan to retire in about one to three years, your time horizon is a bit shorter, but by no means short! Inflation may be your biggest enemy because the cost of living will most likely exceed your income after a few years of retirement. Stocks and stock funds can help take care of the dreaded effects of inflation, but you should use your bond portfolio to hold down the volatility of the overall portfolio. Thus, you need to be a bit more conservative. Your bond portfolio should look like this:

- **Short-term bond fund:** 45 percent
- **Intermediate-term bond fund:** 35 percent
- **Inflation-protected securities:** 20 percent

This bond allocation should be sustainable throughout most of your retirement years. After it's clear you're in your final years and that your current assets will sustain you for the rest of your life, a 100-percent short-term bond allocation is advisable.

REMEMBER

Short-term bond funds suffer the least in turbulent times. So if in doubt, go short! But remember that you may be giving up growth or yield if you put too much in or stay in the short-term arena too long.