



Bond Investments

In the rising interest rate environment of the last two years, money markets and Certificates of Deposit have often outperformed bonds. However, since then we have evolved into a more stable interest rate environment that could be much more favorable to bond investments.

One of the mistakes I see people make in evaluating their bond returns is to only consider the yield. At the current time, many bonds have a yield of 4%-7%. Bonds have a certain yield to maturity, but they also have a fluctuation of principal, if not held to maturity. Bond mutual funds have a continuous fluctuation of principal. As far as I am concerned, bonds and other fixed income investments must be viewed as a "total return asset". In other words, we must combine the yield and the fluctuation of principal to arrive at the total return. If a bond mutual fund yielded 5% last year but lost 2% of principal value, it really only showed a net return of 3%. That is the "total return".

As we know, the principal value of a bond varies inversely to interest rate fluctuations. Over the last two years, the principal fluctuation has experienced downward pressure due to steadily rising interest rates. Prior to that, we had a number of years of falling interest rates which allowed the principal fluctuation to rise accordingly. Moving into 2007, it looks as though we could have fairly flat interest rates throughout the year. If that proves to be the case, then the "yield" could be close to the "total return" since we would have very little fluctuation of principal. Over the last 10 years we have had significant fluctuations in interest rates. This has made for far more fluctuation of principal than in prior decades, with the exception of the 70's, which was perhaps the most volatile single decade ever, with interest rates moving from 8% to 17%. Investors who were in long-term bonds at that time experienced downward fluctuations of principal approaching 50%. In any case, it is important to have a general understanding of bonds and a specific

understanding of the actual bond mutual fund or individual bond before committing to your bond investment.

For me, "fixed income" investments are a necessary part of every investment portfolio. They act as a more conservative vehicle than stocks or stock mutual funds thereby adding balance to a portfolio with the net effect of potentially decreasing overall volatility. Fixed income fluctuations do not correlate to the fluctuations of the stock market so they also act as a good diversification vehicle. Whether our fixed income investments include both Certificates of Deposit and Treasury Bills, or Individual Bonds or Bond Mutual Funds, it is important for each of us to understand the true nature of our specific investment choices. Do they have principal fluctuation? If so, how much fluctuation might we expect and why? Are the bonds corporate or government? If corporate, what is their quality rating? Knowledge is power, so be sure you have as much information as possible about your investments.

Stock Market Corrections

One thing that differentiates stocks from real estate is the short-term volatility of the stock market. Between July of 2006 and February of 2007 we have had 8 straight months of positive growth totaling gains of over 17%. During periods like this we must contemplate the possibility or even increased probability of a correction. Normal healthy stock market corrections are usually defined as downward corrections not exceeding 10%. It is impossible to know exactly when these healthy corrections will occur. However, as we enjoy each month of positive growth, we become conditioned to expect that happen-

ing each and every month. So, when a correction finally comes, it is an unpleasant experience. It is important to put corrections into context and understand how healthy and necessary they really are. An "organized" stock market goes through a regular process of backing and filling. It is sort of a pattern of 3 steps forward and 2 steps back. When this happens, we can make steady gains that compound on themselves year after year. At a certain point, a condition of over-valuation occurs which is a precursor to a more major correction, vis a vis, the 2000 - 2003 bear market correction.

Bear market corrections usually exceed 20%. The occurrence of smaller, healthy corrections on a regular basis can serve to prolong the period of time between bear markets. So, that is really a good thing. To the best of our abilities we should welcome these healthy corrections whenever they do occur, knowing that they are in our best interest for the long-term.

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