
# Bonding with your Portfolio

Nearly all investors realize the importance of ***diversification*** to the investment process. Many may not be as familiar with the importance of **asset allocation—** dividing your portfolio into the appropriate mix of **stocks, bonds,** and cash. Although assets can also include real estate (homes, vacation homes, and rental properties) or business ownership, the most widely held asset classes are stock, bonds, and cash.

In a strong economic climate, the potential for gain when stocks perform well opens up. Typically, most people who invest in the stock market also see value in having a liquid cash reserve set aside for emergencies and larger expenditures. But, what about bonds? Are they affected by economic swings and what are the risks involved?

There is **interest rate risk** associated with investing in a bond or bond mutual fund, referred to as an ***inverse*** relationship. This means that as interest rates rise, generally, prices of existing funds with lower interest rates will fall, and vice versa.

When considering bonds in an investment portfolio, market strategists vary their recommendations from 50% bonds—for the most conservative—to 35% for a more aggressive investor. Your personal **risk tolerance** is a good guideline for deciding the percentage of bonds you want in your portfolio. Some practical reasons to own bonds are: They may generate more income than stocks or cash and, sometimes, the income is free from state or federal taxes. In addition, bonds can be timed to mature when money is needed for a specific purpose, such as college tuition.

## Corporate Bonds

When buying **corporate bonds,** you may want to stick to the higher-grade issues: bonds rated A to AAA. Bonds below these grades, despite sporting higher interest coupons, are riskier. Maturities in the intermediate range of five to10 years are generally considered to be in the "sweet spot" on the yield curve. If you have enough money, consider buying several different maturities in this range to avoid all of them coming due at the same time. Selling a small bond lot may penalize you, so consider holding the bonds to maturity.

## Municipal Bonds

**Municipal bonds,** which generate income that is free from Federal taxes (and from state and local taxes for investors who reside in the state where the bond is issued), are generally a good investment for those in high tax brackets, especially residents of high tax states such as California and New York. Because of their popularity, there is usually an ongoing schedule of municipal offerings throughout the year. Municipal bonds are also rated, and it may be safer to stick with the higher-rated bonds. For smaller investors, the bond portion of their portfolio can be obtained by investing in a **bond mutual** fund.

## Bond Funds

Bond funds, or mutual funds that invest in bonds, are more flexible, and can be bought and redeemed more easily than individual bonds. When you buy a bond fund, you are buying diversity. That is, you are spreading the credit risk among a number of issuers. You are also getting professional management, which should help the fund weather interest rate fluctuations. Also, many funds have special features such as automatic dividend reinvestment and check-writing privileges.

In most cases, a bond will mature at par or face value, while bond funds fluctuate with changes in interest rates. The managers of these funds are always repositioning the funds to maintain the stated maturity, which can be positive or negative, depending on the direction of interest rates.

Bond funds also enable investors to tread territory that may be a bit off the beaten investment path. Examples of specialized funds include **high yield (junk bond)** funds, **international bond** funds, and **emerging market bond** funds. There are also **multi-sector bond** funds that combine **government bonds, foreign bonds, corporates, mortgage-backed securities,** and **inflation-protected bond** funds. When venturing into this more exotic realm, it is prudent to research a fund manager's track record for performance and consistency.

As with investments in all mutual funds, investors should also remember there are specific fees and expenses associated with the management of a bond fund. Any fees and expenses should be outlined in the prospectus and should be considered before investing.