Investing in Bond Funds

If you don't want to invest all your assets in the stock market, you may need to consider either cash or bonds for your portfolio. While cash is relatively safe, returns are likely to be less than 1% given the low interest-rate environment. Bond funds are an alternative but most people don't have a good understanding of what to expect. You may want to consider buying a bond fund to give your portfolio stability or help generate income. Unlike individual bonds, bond funds hold a number of fixed-income securities with varying maturities. Therefore, investing in a bond fund provides a diversification benefit. In order to save yourself from making costly mistakes, it helps to thoroughly check up on what a bond fund owns before you buy in. Two basic determinants of bond performance are interest-rate sensitivity and credit quality.

Interest-rate sensitivity is important because an inverse relationship exists between bond prices and yields. If interest rates fall, bond prices rise, and vice versa. The credit quality tells you how risky the bond fund is, which can help determine if the fund fits your risk profile. Consider these factors before you go bond-fund shopping. Just as you wouldn't want to have all of your stocks in one style, you also want to diversify your bond portfolio. A well-rounded bond portfolio should have some exposure to most of the following bond types: Government, mortgage-backed, municipal, corporate, and world bonds. It is important to understand that the right combination of bond funds ultimately depends on your investment goals and risk profile.

Diversification does not ensure a profit or protect against a loss in a declining market.

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Advisor Corner

Cindy Menker, CFP™, CPA, MBA is President of Contour Financial, Inc. The firm, located in Orland Park IL, specializes in retirement planning and investment management. Tax planning, including tax preparation, is also offered.

Cindy is a member of the National Association of Personal Financial Advisors (NAPFA), the financial industry's leading organization.

One requirement for membership is that Contour Financial be "Fee Only", meaning that all fees be fully disclosed to the client.

For archived newsletters and interviews visit the "Current Clients" tab found at ContourFinancial.com. Cindy has been interviewed by local and national publications including Money Magazine, Elite Magazine, and the Chicago Tribune.

Feel free to forward this newsletter to your friends and family. Provide us with their email addresses so that they do not miss out on any future issues.

Bond Basics

Benefits of investing in bonds: Potential for growth, historically lower risk, diversification and income are some of the benefits of investing in bonds. Generally, bonds have provided investors with growth and historically demonstrated less volatility than stocks. Because economic events that decrease stock prices tend to increase bond prices, and vice versa, adding bonds to a portfolio can provide diversification benefits. Bond investors generally receive income at fixed intervals that can be used to offset cash obligations or increase portfolio liquidity.

Bonds and interest rates: There exists an inverse relationship between bond prices and yields. If interest rates fall, bond prices rise and vice versa. Suppose an investor purchases a 20-year $1,000 bond with a yield of 8% and interest payable annually. One year later, interest rates rise to 10%. Anybody in the market for a bond can now buy one with a yield of 10%. If the investor tried to sell the bond with an 8% yield for the original price of $1,000, nobody would buy it—the same amount of money could purchase a bond yielding 10%. In order to find a buyer, the investor would need to discount the bond price to compensate the buyer for the lower interest or coupon payments (10% – 8% = 2% less per year in interest payments).

Diversification does not ensure a profit or protect against a loss in a declining market. Bonds are subject to credit/default risk, which is the risk associated with the issuer failing to meet its contractual obligations either through a default or credit downgrade. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

Borrowing from Your Retirement

Barbara is 40 years old, has a child in college, and needs to take out a loan to help with tuition. She is considering either a home-equity loan or a loan from her 401(k), and is not sure which would be the better choice. She has heard that taking out a loan from a 401(k) is painless, since "you don't pay penalties and pay the interest to yourself, not to a bank." What should she do?

Many 401(k) plans offer a loan provision and the process is fairly easy. There is no credit check (since you are borrowing from yourself); the interest rate is usually low (maybe a percentage point or two above prime); you can generally borrow up to 50% of your vested account balance to a maximum of $50,000; you have up to five years to repay the loan (longer for loans used to purchase a primary residence), and the plan administrator usually deducts the loan payments automatically from your paycheck.

However, the real cost of borrowing from your 401(k) is not the rate you pay yourself in interest, but the amount you would have earned on your balance had you just left the money in the account. This is called an "opportunity cost," and it can be significant. In addition, if Barbara loses or changes jobs, a 401(k) loan will most likely come "due in full" within a limited amount of time, while a home-equity loan will not. The balance is taxed as if it were ordinary income and, unless she is at least 59½ years old, failure to pay the 401(k) loan back by the due date triggers a 10% penalty.

So, what are Barbara's choices? In general, if she can take out a home-equity loan at a lower after-tax cost than the return she expects to receive on her 401(k), she should choose the home-equity loan.

What Is a Credit Score?

Ever wondered why your application for a credit card was declined? How the interest rates on your loans were determined? Or what those advertisements about getting your free credit report mean? All of these are related to one's credit score.

What is a credit score? It is a system that creditors, like banks, use to determine whether to extend credit to you, the consumer, based on the probability that you will repay the loan and make the payments when they come due. In addition, it is sometimes used to determine the interest rate on the loan. Generally, scores above 720 are considered excellent and you will qualify for most loans. If you have a score in the high 600s to 700s, you will qualify for most loans but not at the best interest rates. Consumers with scores below the mid-600s may not be able to qualify for credit cards loans, and even if they do, would have to pay unattractive rates. So what are the factors that determine your credit score and what steps can you take to improve it?

First, your payment history is the most important component of your credit score. If you have paid bills late or declared bankruptcy, this will lower your score. The best way to keep up with your monthly payments is to live within your means and only use credit cards if necessary. In addition, try to set up an emergency fund to protect you from unexpected expenses or changes in your income, like losing your job.

The second component looks at the amount you owe, or your debt-to-credit ratio. You should have some debt on your accounts to show that you are able to handle credit, but if the amount you owe is close to your credit limit, it is likely to have a negative effect on your score. In addition, some credit card issuers have been reducing lines of credit for customers who have not have any late payments, which will have the effect of increasing your debt-to-credit ratio so make sure to call your issuer to get this reversed if you are affected.

The length of your credit history looks at how long you have had a credit track record and considers the time since your accounts were opened and they were last used. Thus, even though you might have some inactive accounts, it is important not to close your oldest accounts especially if you have a relatively short credit history of less than 10 years.

Fourth, creditors look at whether you have inquired for new credit lately. Do not apply for too many accounts within a short period because it makes it look to creditors as though you are desperate for credit. If you need to make multiple inquiries for home or car loans, or for credit card applications, do it within a short period of time, between 14 to 30 days, so that it will be treated as a single inquiry. Speak to your financial advisor on the best ways to apply for new credit if you need to.

The last factor used in determining your credit score is the types of credit that you have. Try to have a good mix of different types of credit, including credit cards, car loans, and mortgages, which might take longer to establish depending on your current level of income. However, refrain from applying for too many credit cards because this may have a negative impact on your score.

To learn more about your credit score, go to Annualcreditreport.com and obtain a free annual credit report from any of the three major providers —Experian, TransUnion, or Equifax. You will not get your credit score with this free report but you will obtain qualitative information based on the five factors mentioned above, and learn whether you have any inaccurate information or unauthorized accounts. If you would like a more detailed report with your credit score, you can purchase the report from the providers.

Monthly Market Commentary

The S&P 500 has risen by almost 7% so far in 2012, causing investors to wonder whether the economy is slowly improving or whether this growth was merely the result of the January effect. Global economic news have generally been positive—it included China's slight drop in fourth-quarter GDP (as opposed to a plunge), a relatively quiet Europe, a positive U.S. employment/unemployment report, and the Federal Reserve's promise to extend low rates through 2014. Corporate earnings have so far been a mixed bag, and Morningstar economists believe that even as the U.S. economy continues to recover, earnings may continue to slow, especially for companies with significant exposure to China and Europe.

GDP: Real GDP grew by 2.8% in the fourth quarter, reflecting an overall positive trend in 2011. Consumer goods and inventories (GDP measures production, whether it is sold or simply sitting on a shelf somewhere) led this growth, contributing 1.3% and 1.9%, respectively, while government spending declined by 0.9%, mainly because of cuts in the defense budget. Morningstar economists believe that the 2.8% growth does not represent the new baseline for 2012, because the results were artificially boosted by unexpectedly good weather, the return of more normal auto production, inventory rebuilding, and shifts in retail employment.

Employment: Employment in January grew by an impressive 243,000 jobs, with 257,000 coming from the private sector, while the number of government jobs shrunk by 14,000. Although job growth rose across most sectors (only finance, information services, and government were down), the surprise came mainly from autos and durable goods, which benefited from favorable weather and large jumps in manufacturing and overtime hours, respectively. Retail also came as a surprise, as declines in seasonal hiring were offset by higher department-store and auto-showroom hiring, which boosted overall retail employment into growth territory.

Unemployment: The unemployment rate in January dropped to 8.3% from 8.5%. More important, this reduction came mostly from job growth as opposed to discouraged workers dropping out of the labor force or ceasing to claim benefits. To date, the U.S. economy has regained 41% of the 8.9 million private-sector jobs that were lost during the recession.

Manufacturing: The ISM Manufacturing survey reported better-than-expected numbers, indicating the third consecutive increase in the index and reflecting continued improvement in the auto industry. New durable-goods orders also rose much higher than expected in December, indicating that the manufacturing sector may be picking up steam and growing stronger.

Federal Reserve: The bold decision to keep interest rates low through late 2014 came as a surprise to many, and markets reacted positively to this unexpected news. Morningstar economists believe that continued low interest rates will actually start to pinch savers and hurt the personal income report in a meaningful way. Furthermore, this extended length of time does not lend any sense of urgency to either potential homebuyers or corporations considering large capital expenditures, further suppressing housing and private-sector growth. Given all the global economic uncertainty, there's almost no point in buying anything today when rates are guaranteed to stay low for the foreseeable future.

Despite the good employment news, the overall outlook remains far from optimistic. Rising prices and stagnant incomes put pressure on savings, while the low interest rate environment offers little yield as stocks continue to struggle. Although everybody is hoping for economic growth, the question remains—where will that growth come from?

About Contour Financial

Contour Financial is a private wealth management business located in Orland Park, Illinois. We work primarily with middle income and wealthy clients. Customized strategies are developed and implemented. Personalized service is provided to clients. Investment, retirement, tax, estate, insurance, cash flow and education planning are all integral parts to the process. As a fee-only firm, all compensation is disclosed.

Investments are a critical component in comprehensive planning. Individuals have different goals, resources, volatility tolerance and time horizons. We tailor portfolios for each client which are continuously monitored and rebalanced semi-annually. For clients seeking active investment management by our firm, assets are held at Charles Schwab Institutional, an industry leader.

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