

In light of the generational lows in Treasury yields, traditional buy and hold strategies involving US Treasury securities via holdings in open-end mutual funds not only present little if anything to get excited about at this time, in our view, but may well leave client portfolios at significant risk to rising rates.

5-year Treasury Yield

Source: Bloomberg, LP



For this reason, we strongly recommend that clients move away from open-fund investing into an individual bond approach, in addition to incorporating risk management into their portfolios (for more details on the latter, see YieldQuest Timely Topic, Bringing Risk Management to Your Bond Portfolios).

The case for rotating into individual bonds

There are a number of compelling reasons why we believe clients should rotate from open-end funds into individual bonds at this time:

- Individual bonds permit clients to maintain professional oversight of their holdings and control the structure of their portfolios, both in terms of credit quality and duration. Indeed, while open end funds tie a client into a relatively constant duration, our individual bond strategies enable us to customize duration based on a client's financial planning considerations, as well as customize their individualized income parameters.
- Whereas open-end bond funds charge a yearly fee for managing the portfolio, clients who purchase individual bonds are only required to pay a one-time charge at the time of purchase typically translating into a higher yield for individual bonds as compared to similar mutual funds.
- Unlike individual bonds, bond funds do not have a defined maturity date, so clients have no way of knowing exactly how much they are getting back, and when (assuming no default).

TIMELY TOPICS

The Advantages of Investing in Individual Bonds A YieldQuest Commentary

Why we believe an individual bond/laddered bond strategy may be superior to a bond fund in a rising rate environment.

Given where we are in the current interest rate cycle, with rates at historic lows, we believe it is particularly prudent for our clients to focus on the first point above – the ability to control portfolio duration offered by individual bonds over open-end funds.

Because most bond funds have high allocations to U.S. Treasuries and agency securities, these funds may leave client portfolios particularly vulnerable to rising rates. Investing in individual bonds via the laddered bond approach we employ at YieldQuest allows our clients much greater flexibility to manage interest rate and reinvestment risk, thereby potentially mitigating any potential price loss as interest rates rise over time. Specifically, because our laddered approach is based on purchasing bonds at maturity intervals of one year, we are able to take advantage of higher rates by reinvesting the proceeds of maturing bonds at higher yields over time. Therefore, we believe a laddered bond strategy may be superior to a bond fund in a rising rate environment.

Here's how it works:

- Our conservative laddered fixed-income portfolios involve purchasing relatively similar amounts of bonds maturing each year (each rung of the ladder) from 2 to 11 years or so - 2011 to 2020.
- As the bonds mature, we will reinvest the proceeds into new bonds at the next rung of the ladder (2021).
- We may extend maturities slightly to 12 or 13 years if interest rates are high, so we can lock in higher rates for longer periods of time.
- In the current environment, however, we would look to shorten the maximum maturity from 10 years to 8 years, because the portfolio would then have a shorter duration.
- This “laddered” strategy may help mitigate price loss as interest rates rise.

Thus, from both a financial planning and performance perspective, we believe individual bonds may help optimize a client's fixed-income exposure.

Why we believe rates are likely headed higher over the next 12-18 months

As recently highlighted in Barron's, the current euphoria over gold and Treasuries and the extreme bearishness on the U.S. dollar are “lopsided trades” that evidence “the most pervasive belief in the market now, that the Fed is preparing a second quantitative easing asset-purchase program...as investors front-run the Fed bid.” From a contrarian standpoint, these extreme levels of sentiment suggest that a reversal in yields, gold and the dollar may well be forthcoming sooner than the market and the financial press would have you believe.

Moreover, the Fed's steadfast commitment to another round of quantitative accommodative policy to help jump start employment and raise consumer prices may leave them behind the curve as economic growth and inflation gain momentum. In other words, we believe this might well turn into a case of “be careful what you wish for,” since the Fed doesn't have a direct means by which to control inflation once prices do begin to rise. As it is, recent economic data – including retail sales, home sales, durable goods orders, regional manufacturing surveys, jobless claims and third quarter GDP have come in better than expected, calling into question the underlying need for additional Fed asset purchases to support the economy.

TIMELY TOPICS

The Advantages of Investing in Individual Bonds A YieldQuest Commentary

Finally, the Fed's initiation of a second round of asset purchases is placing increased pressure on other central banks to follow suit, given the significant depreciation in the dollar vis-à-vis the currencies of its trading partners and the negative impact this is having on their own export-driven recoveries. For example, according to Credit Suisse, every 10% gain in the euro on a trade-weighted basis reduces GDP growth by 0.8 percentage points, while also slashing about 11% off European corporate earnings. With global central banks once again biased towards potentially more, rather than less, accommodation, we believe this only raises the probability of higher-than-expected inflation (and therefore higher bond yields) globally.

Capitalizing on Inefficiencies in Individual Bonds

In addition to the aforementioned factors, we have also found a number of inefficiencies to exist in the individual bond marketplace that we believe may be exploited to our clients' benefit, thereby further enhancing the attractiveness of individual bonds over open-end funds:

➤ *“Odd Lot” Bonds*

Most demand in the municipal and taxable bond markets come from institutions and large wire-house brokers. Because these firms are investing large sums of money, they will typically not purchase bonds that are less than \$100,000, and in some cases, even less than \$1MM. Because demand is less for smaller pieces (odd lots of \$5,000 bond pieces to \$100,000 bond pieces), we can often times buy these bonds, on the municipal side, 20 to 40 basis points (.2% to .4%) cheaper than institutions buy the larger blocks. This is another way for us to add yield relative to bond funds. It may be counterintuitive, but smaller lot sizes are cheaper than larger ones, given the relative lack of demand for these size lots. This same inefficiency exists on the taxable bond side of the fence, but is not as prevalent as in the muni market.

➤ *High Coupon Bonds*

If you were to purchase a 10yr muni bond with a coupon of 4%, and a yield to maturity of 4%, the price for the bond would be par (100). Assume now you see a second bond, also a 10 year maturity, but with a coupon of 7% (instead of the 4% in the example above). The market would not allow you to pay par (100) for that bond, as you would be getting a 7% return when 10-year rates are only at 4%. You would therefore have to pay much higher than par (around 124 dollar price), to equate the higher coupon received to the market rate of interest. In other words, for a \$10,000 face value bond, you would have to pay around \$12,400.

Some investors might wonder: 10 years from now, I will only be receiving back \$10,000. How is this good deal? The 7% coupon you are earning over the next 10 or so years will more than make up for the \$2,400 “loss” of principal. Most individual investors do not understand bond arithmetic, so they will avoid bonds with high coupons that are trading at premiums. This lack of demand allows us to pick up extra yield as well. In this example, we could probably buy the premium bond at a 4.25% YTM, vs. 4% for the bond priced at 100. These opportunities are present in both the municipal and taxable fixed-income markets.

➤ *Zero Coupon Bonds (Zeros)*

Because many investors in the fixed-income marketplace utilize the income generated from their portfolio, they do not want to hold bonds that pay no interest. Zeros are purchased at a discount (below par), and come due at par or some higher price at some point in the future. Your return is simply the capital

TIMELY TOPICS

The Advantages of Investing in Individual Bonds

A YieldQuest Commentary

gain you achieve by purchasing at a discount, and coming due at a higher price. Lack of demand means we can generally purchase them cheaper, hence adding to the return in your portfolio. When we combine zero coupons with higher premium bonds, we can offset some of the premium paid on the higher coupon bonds, as well as achieve a higher overall portfolio yield.

➤ *Callable Bonds & Sinking Funds*

Many issuers of municipal and taxable bonds have retained the right to call a bond prior to its stated maturity date. If you were to have a portfolio that was built entirely of all callable bonds, you would not have a very high degree of control over what was coming due and when. Because this is a risk to the investor, callable bonds can typically be purchased cheaper than non-callable issues. When buying callable bonds, we seek to avoid longer maturity bonds with shorter call dates, but rather look to build as much “call protection” into the portfolio as possible. While we like callable issues from the yield stand point, we typically limit callable bond exposure to a reasonable amount given our desire to maintain control over cash flows.

Sinking fund bonds have partial, random calls. Unlike a “regular” call provision as outlined above, whereby the issuer has discretion as to whether or not a bond is called, the sinking fund schedule is set up upon issuance of the bond, so an investor knows how much is being called away, and when. Because most investors don’t understand sinking funds, we can often times purchase them considerably cheaper than non-callable issues.

In summary, while we believe that an investment strategy favoring individual bonds vis-à-vis open-end bond funds may be superior in any economic environment, we feel this is particularly true given today’s record low interest rates. Indeed, we would argue that the ability to manage duration, interest rate and investment risk afforded by an individual bond strategy is particularly critical now, in light of our view that rates are likely to rise from these levels, potentially significantly so, over the next 12-18 months.

We welcome the opportunity to discuss our individual bond strategies in more detail with you, and encourage you to contact your YieldQuest representative with any questions or comments you may have at 1-866-978-3781.

TIMELY TOPICS

The Advantages of Investing in Individual Bonds A YieldQuest Commentary

Securities offered through YieldQuest Securities, LLC (Member FINRA and SIPC)

Implementing individual bond strategies may require considerably more investment capital than investing in bond mutual funds. There can be no guarantee that the aforementioned strategies will be implemented successfully. High coupon bonds may be subject to greater volatility and default risk than bonds of higher quality. Zero coupon bonds may be subject to greater volatility and carry tax implications that are different from traditional coupon bonds.

Past performance does not guarantee nor is indicative of future results. This summary of statistics, price, and quotes has been obtained from sources believed to be reliable but is not necessarily complete and cannot be guaranteed. All securities may lose value, may not be insured by any federal agency and are subject to availability and price changes. Market risk is a consideration if sold prior to maturity. Information and opinions herein are for general informational use only and subject to change without notice.

This material does not constitute an offer to sell, solicitation of an offer to buy, recommendation to buy, or representation as the suitability or appropriateness of any security, financial product or instrument, unless explicitly stated as such. This information should not be construed as legal, regulatory, tax, personalized investment, or accounting advice. This message (and any attached materials) is for the sole use of the intended recipient(s) and may contain information that is privileged, confidential and exempt from disclosure under applicable law. Any review, dissemination, distribution or duplication of this communication is strictly prohibited. If you are not the intended recipient, please contact the sender immediately by reply e-mail and destroy all copies of the original message.

Any YieldQuest model portfolio holdings and benchmark data are for illustrative purposes only and should not be construed as any type of research. This data is not meant to replace Adviser's portfolio management/performance reporting systems. Please consult your Adviser's performance reports for actual performance data before making any decisions based on this information. Accordingly, reliance upon information in this article is at the sole discretion of the reader.

Investors should carefully consider the investment objectives, risks, charges and expenses of the YieldQuest Funds. This and other information about the YieldQuest Funds is contained in the prospectus and should be read carefully before investing. The Fund's prospectus can be obtained by calling 866-973-8637. Investors should note that mutual fund values may fluctuate and that the fund's price or value may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not indicative of future results. YieldQuest Advisors is the Advisor to the YieldQuest Funds. The YieldQuest Funds are distributed by YieldQuest Securities, LLC (Member FINRA, SIPC).

Additional information available upon request.

ADV-0141-001-246