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Money Minute

"Smart Ideas for Secure Finances"

Financial Planning & Investing Newsletter

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When is the Right Time for Bonds or Bond Funds in Your Portfolio? Part 3

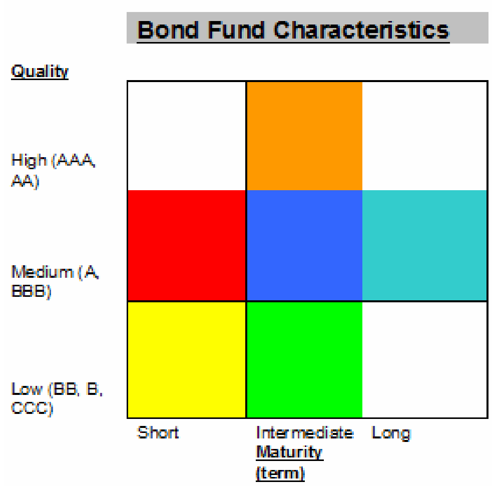
Over the past two months, I've examined the general character of bonds, their less volatile returns as compared to stocks, and the specifics of how bonds and bond funds generate returns. I also introduced the two most important characteristics of any bond. This month, I will take a closer look at a handful of bond types and examine potential uses for each.

To review, the two characteristics that most fully define a bond are:

Quality – A bond's quality can be thought of as the credit-worthiness of the entity issuing the bond. High-quality bonds carry high ratings from ratings agencies like Moody's and S&P, and these bonds are deemed to have a low risk of default. For example, companies with strong financials and the U.S. government carry high ratings and are thought to have a low risk of default. (There is little doubt that the U.S. government will make timely interest payments and repayment of principal since it can print money!) Companies with weak financials and those losing money can issue bonds, but they will carry lower ratings. All things being equal, investors demand higher interest payments for bonds issued by weaker companies than those issued by stronger companies, in the case of corporate bonds.

Term / Time Until Maturity – The length of time until a bond matures is the other important factor in understanding a bond. For example, all other things being equal, bonds that mature in 10-15+ years are considered riskier compared to those maturing in 3-4 years. The longer the time until maturity, the greater chance that something could go wrong with the issuer of the bond, and the greater the chance an investor does not receive his money back. In short, the more time an investor has to part with his money, the greater the risk. Hence, all other things being equal, bonds with longer maturities pay greater interest than those with shorter maturities.

The vast majority of individual investors purchase bonds via mutual funds in their IRAs, 401(k)s, etc., so I will focus the rest of this article on bond fund options. All bond funds can be assessed by the average quality of the bonds it holds and the average time to maturity of the bonds it holds. Broadly speaking, quality can be looked at as either high (rated AAA or AA), medium (rated A or BBB) or low (rated BB or below), and time until maturity can be characterized as either short (1-3 years), intermediate (3-7 years) or long (8+ years).



While most 401(k)s offer one or two bond fund options, there are many more distinct categories of bond funds available for investment. For individuals who are investing in an IRA (after a 401(k) rollover for example) or in a taxable investment account, it is important to understand these other options. I have highlighted six categories of bond

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QUOTE OF THE MONTH

Anyone who obeys the law and likes sausage should never watch either one being made.

~Benjamin Franklin
Statesman / Inventor
(1706 - 1790)

DID YOU KNOW?

FedEx and UPS delivered an estimated 947 million packages between Black Friday and Christmas Eve in 2015. The UPS facility in Louisville, KY can process up to 416,000 packages per hour.

Source: NBC News

Potpourri ---Stock, Company & Market News and Notes---

Gillette Sues Competitor, Chipotle Still Reeling, Oil Export Ban Lifted, etc.

Industry leader **Gillette** is suing upstart competitor **Dollar Shave Club** of patent violations, claiming the way certain materials coat Dollar Shave Club's blades violates a 2004 patent held by Gillette. Gillette has roughly 70% of the razor market across the world. It is owned by Proctor and Gamble and had $7.4 billion of revenue in its most recent fiscal year. Dollar Shave Club, started in 2011, has roughly 2 million members and about 10% of the U.S. market for men's razors. Gillette started a competing subscription service for its razors in 2015.

Chipotle Mexican Grill's problems with E Coli have gotten worse over the past month, and federal authorities are conducting a criminal probe tied to an outbreak of illnesses at one of the company's locations in Simi Valley, CA. That outbreak sickened 234 people. Other outbreaks occurred in Seattle, Boston, and several stores in Minnesota. Company-wide sales were down 14.6% in the 4th quarter, and December sales were down 30% compared to the previous year. The company's stock is down 33% as of January 6, 2016 from where it traded in October prior to the outbreak.

Chicken of the Sea's parent company **Thai Union Group** has abandoned its planned acquisition of San Diego-based **Bumble Bea Seafoods** after U.S. authorities said the deal would be harmful to competition in the seafood market. The deal was worth $1.5 billion. The canned tuna market is dominated by three brands - the third being Pittsburgh-based **Starkist Co.** Starkist has a 36% market share in the U.S. and was bought in 2008 by South Korea's Dongwon Industries Co. U.S. canned tuna consumption peaked in the mid-1980s, and per capita consumption has declined by almost 50% since that time. Canned tuna accounts for roughly 16% of all seafood consumed in the U.S.

Struggling cosmetics company **Avon** has sold 80% of its North American business to private equity firm Cerebrus Capital Management for $605 million. Avon generates 85% of its revenue from its international business. Avon last turned a profit in 2011, and turn around efforts have been ineffective. Since 2011, annual sales have fallen by 25%, and the company's stock price has fallen by over 80%.

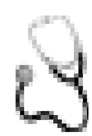
Last month, **Facebook** CEO Mark Zuckerberg pledged to give away 99% of his Facebook stock during his lifetime, valued at roughly $45 billion when the announcement was made. Zuckerberg has already donated $1.6 billion to charity over the past decade.

The U.S. Congress voted to repeal the **40-year old ban on exporting crude oil** last month. The lifting of the ban comes at a time when the world is facing a glut of oil and gas that has seen prices of a barrel of oil fall to an 11-year low of $32 per barrel (as of January 8th), down from over $100 in the summer of 2014. The lifting of the ban is not expected to lead to any substantial exports for months. Oil producers around the world continue to struggle and adapt to the low price of oil.

Gap Inc., parent company of Gap, Old Navy and Banana Republic stores, reported continued struggles last month. Overall sales fell 5% across the three stores, with Banana Republic clocking a 9% decline, Old Navy sales down 5% and Gap sales down 2%. Old Navy had been the one bright spot for the company over the past year, but Old Navy president Stefan Larsson left the company in October to become CEO of Ralph Lauren.

The Federal Reserve raised its key interest rate last month for the first time since 2006, a sign of confidence in the economy. See this month's Up Close story for details.


YOUR HEALTH




Cognitive Long-term Effects of Alcohol Consumption Revealed

New research suggests that heavy drinking, even for those who never get drunk or seem to have an addiction to alcohol, leads to various forms of cognitive decline as we age. Brain imaging shows that heavy drinking causes structural changes to parts of the brain that control learning, memory, decision-making and social behavior. So-called gray matter and white matter break down at an accelerated rate and causes symptoms that are often confused with Alzheimer's disease, other forms of dementia and normal aging. Researchers at Stanford University describe the brain images of chronic heavy drinkers as looking prematurely old. Other changes take place in areas of the brain that help control how individuals regulate their emotions and deal with anxiety.

What is considered "heavy drinking?" Researchers are hesitant to give blanket rules, but the National Institute of Alcohol Abuse and Alcoholism says that men should have no more than 14 drinks per week and 4 on any given day, while women should have no more than 7 drinks per week and 3 on any given day. This new research does not conflict with the many studies showing that people who drink moderately have a lower risk of cardiovascular disease, depression and cognitive issues than those who do not drink at all. It does, however, suggest that there is a fine line between achieving health benefits and potentially causing harm to oneself with regular alcohol use.

Researchers have seen mixed results when determining how much alcohol-related brain damage can be undone when a person stops drinking. Researchers at Harvard University has seen white-cell brain damage repair itself in cases where a person stops abusing alcohol by age 50. Researchers at Stanford University have seen individuals who once abused alcohol perform as well on cognitive tests as those who have never abused alcohol, though they often used different pathways to complete the same tasks.

*Source(s): Wall Street Journal Health

Readers' Q&A

Questions? E-mail Brad@R1FinancialGroup.com

Q. "I've never selected any international funds as investments in my 401(k) or in my IRA. I don't know if this is wise or not. Should I add a percentage of these?"

-Charlie – Grapevine, TX

A. Most financial advisors and fund companies include 15% – 35% international stock funds as part of the stock allocation in a portfolio. Fund companies that offer target date retirement funds will almost always include a sleeve of what are known as "developed market" stock fund(s), which focus on first-world countries in Europe, Australia, Japan, etc. Some will also offer so-called "emerging markets" stock funds, which focus on companies domiciled in countries like China, SE Asia, India, Brazil, Russia and elsewhere. These additions are done to add a layer of diversification to a portfolio and capture part of a different opportunity set than the U.S. alone provides. Broadly speaking, I think it's reasonable to include international funds in a stock fund portfolio. That being said, U.S. funds have generally outperformed their international counterparts over the past 5 years, so diversification in this respect has hurt total returns during this period of time. However, in the decade prior to the financial crisis, international funds generally performed better than U.S.-focused stock funds.

Be sure to do some research into any potential funds you are considering, and feel free to contact my office for more assistance.

Q. "I'm retiring within the next 2 years and am trying to figure out how much I can comfortably withdraw from my accounts each year and not run out of money. Is there any general rule here?"

-Denise – Plano, TX

A. As a matter of fact, there is. A well-known financial planner published a paper in the 1990s on this subject, and it looked back at historical stock and bond market returns to determine what rate, even under the worst of conditions, would have been a "safe" rate of withdrawal and made a person's money last for at least 30 years. The answer was: 4%. Even under the worst of historical market conditions, a 60% stock, 40% bond portfolio supported a 4% withdrawal rate for a 30-year retirement. The worst conditions were those in which a person retires just before a sustained period of market declines (1929, 1966, etc.). In many cases, a 4% withdrawal rate would have resulted in individuals ending up with larger ending balances compared to where they began, even after 30 years of withdrawals.

In practice, retirees should monitor their spending and portfolio's performance annually to determine if they should decrease their withdrawals or if they can safely increase their withdrawals over time. As a general rule, the "4% rule" is a good starting point to consider as you begin your planning.

Financial Planning Corner

*Personal Finance *<u>*Insurance Planning*</u> *Investments *Retirement Savings *Education Savings *Retirement Income Planning

<u>Highlighted Topic</u>: **Long-term Care Insurance**

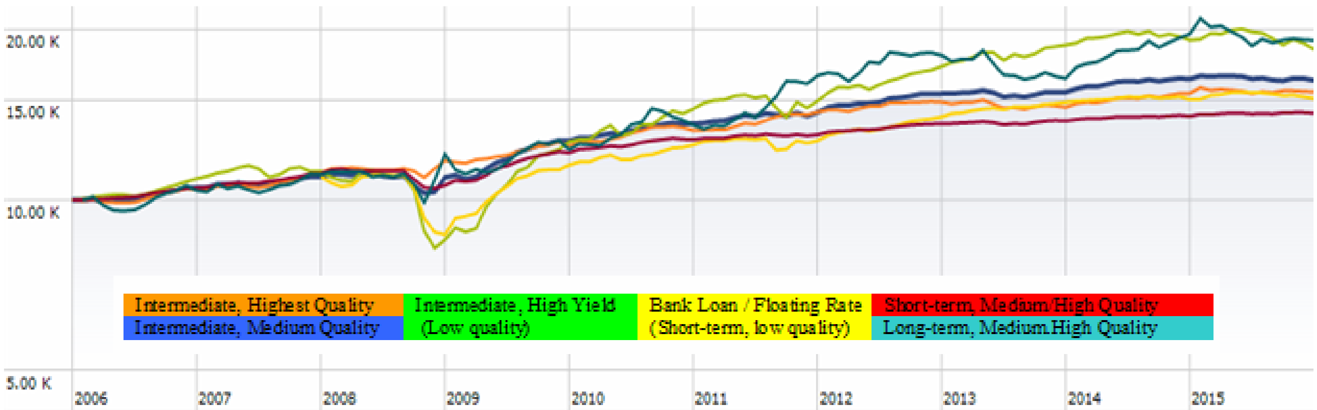
<u>What You Should Know</u>:

- Long-term care insurance policies pay benefits to policyholders should they need care in a nursing home, assisted living facility or from a home health aide in their homes. When a person needs help with activities like bathing, getting dressed, eating, going to the bathroom, etc., policy benefits are paid. Medicare generally does not pay for these types of benefits.
- Individuals and couples generally buy such insurance policies when they are in their early 50s to mid-60s. Policies allow individuals to choose a monthly benefit amount and a maximum number of years of coverage, along with an inflation factor.
- LTC insurance policies can cost $200-450+ per month for a couple depending on desired coverage levels, age and options selected. The significant cost reflects the high cost of assisted living, nursing homes and home care services in the U.S. Medicaid is the largest payer of nursing home costs in the U.S., but going on Medicaid requires a person to spend virtually all of their assets on nursing home costs first.

<u>Brad's Opinion</u>: This is a very difficult retirement planning issue for most people. It can be uncomfortable to think about a time when such care could be needed, but it is important to have a plan in advance, particularly those who want to leave assets to heirs and/or charities. Everyone over age 50 should consider his or her options, including LTC insurance.

When is the Right Time for Bonds or Bond Funds in Your Portfolio?

(Continued from page 1)



funds centered on the various intersections of quality and maturity, and I have shown a hypothetical investment of $10,000 in a fund in each of these categories from Jan. 2006 through December 2015. (See above)

The **orange line** represents a high-quality, intermediate term bond fund similar to what is offered in almost all 401(k)s. Such funds are often comprised of mostly U.S. Treasury bonds and other very highly-rated agency-backed and corporate bonds. They are considered virtually credit risk free.

The **blue line** represents a medium quality, intermediate-term bond fund. Such a fund would invest in bonds of mostly corporations (as opposed to U.S. Treasury bonds), making it have greater credit risk. Such funds own bonds that carry higher interest rates than comparable Treasury bonds to compensate for this increased credit risk. This fund had more fluctuation in value, but it showed a higher long-term return than the previous fund.

The **green line** represents a low quality, intermediate term bond fund. Such a fund would invest in the bonds of highly-indebted corporations that carry a far greater risk of default. Most notably, you can see the sharp decline in value of the green line during the financial crisis and when the U.S. economy was very unstable. You can also see the strong recovery in value and strong subsequent growth over the following years. This is the opposite of what most people expect from a bond fund, and performance of these types of funds is more correlated with the direction of the stock market.

The **red line** represents a short-term, higher quality bond fund. What stands out here is that this line is the most stable due to the fact that it holds short-term, high quality bonds. It also had the lowest return over this 10-year period, which makes sense given its lower overall risk profile. The yellow line represents a short-term, low quality bond fund, and the **turquoise** line represents a long-term bond fund, both of which can be very volatile in their returns. One carries a high degree of credit risk, and the other carries a high degree of interest rate risk, which are responsible for this volatile nature.

The points to take away are that: 1) there are numerous options available in the world of bond funds, all with widely-varying characteristics and 2) the same risk vs. reward tradeoff that applies to other investments applies here as well: greater risk equals greater potential reward. These examples should not be taken as a recommendation of any type of bond fund but should act simply as an introduction. You should consult your advisor and fully understand the risks and characteristics of these categories of bond funds before investing.

Next month, I will add some additional commentary on potential uses of these categories of bond funds and conclude this feature on bond funds.

Market and Economic News

-Economic growth (measured by gross domestic product - GDP) for the 3rd quarter of 2015 was revised downward from +2.1% to +2.0%. 4th quarter economic growth is forecast to be a very weak +0.7%, and this information will be released in late January.

-December's Bureau of Labor Statistics employment report showed a gain of 292,000 jobs, far above expectations. The unemployment rate remained at 5.0% during the month.

-The major U.S. stock market indices started off the year with their worst opening week in history, losing 6 – 8% during the week of January 4 – 8. Persistent fears of a slowdown in growth across the globe, particularly in China, have dogged stocks for the past 6 months.

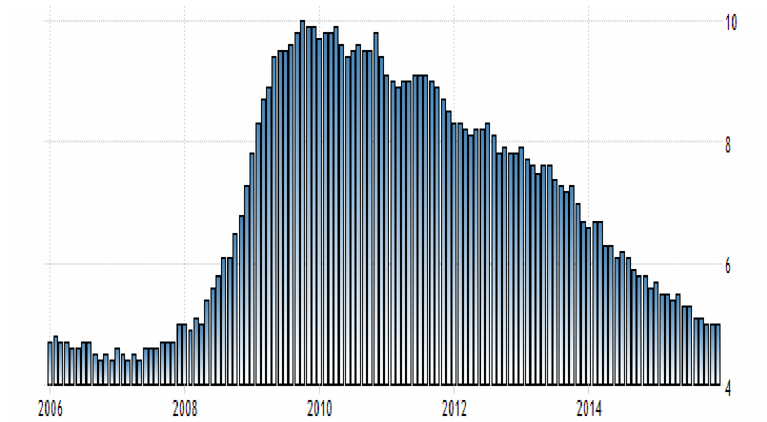
At a Glance…
(as of January 8) **DJIA** – 16,394 **S&P 500** – 1,922 **NASDAQ** – 4,642 **10-yr T-note** – 2.16%

Fed Moves Interest Rate Higher for First Time Since 2006

In mid-December, the Federal Reserve raised its benchmark Fed Funds rate for the first time since before the financial crisis and Great Recession of 2007-2009 began. The move took the interest rate range from 0 - 0.25% up to 0.25 - 0.50%, meaning this was a modest move higher but a significant move in that it represents a vote of confidence in the economy by U.S. central bankers.

Federal Reserve Benchmark Interest Rate

U.S. Unemployment Rate



Source(s): Trading Economics

What finally led to the interest rate increase? The Fed's policies are designed to lead the economy to what it calls "full employment" and a targeted rate of downward trajectory since 2010. As for inflation, the Fed has stated a target of 2% annual inflation, and though the economy is still now achieving this figure, the Fed saw enough progress toward this goal to begin raising rates. It has said it anticipates four more rate hikes during 2016, but that those will depend on how the economic data reads throughout the year. Also notable was the fact that 2015 saw its strongest wage growth since 2009. Wage growth in December was 2.5% higher than a year ago, and the economy added a whopping 292,000 jobs in December. Wage growth of 3 - 4% is more typical of such strong hiring, and that is something to look for in 2016.

What effect will consumers see as a result of this interest rate hike? In the short term, not much. The Fed does not directly control interest rates on intermediate and longer term items like car loans and home loans. Banks may begin charging slightly higher rates on short-term borrowing and offer slightly higher rates for short-term deposits, but it will take a more broadly recognized improvement in the economy for longer-term interest rates to rise. In short, inflation, wage growth and total economic activity need to pick up the pace.

The Fed's historic move to raise its benchmark interest rate is certainly noteworthy. Now, it's time to see if the economy can follow through and justify more rate increases in 2016.

Editorial: *Should the Feds Restrict Who Can Borrow Money for College?*

The problems facing the federal student loan program have been well publicized over the past several years, and I've written about this topic a couple of times over the past two years. The ballooning size of the program, tripling to $1.2 trillion over the past 12 years, and the rapidly rising delinquency rate to almost 12% from just over 6% in 2007 have made headlines in many publications. Excluding borrowers still in school, roughly 25% of all student loan debt is at least 90 days past due. These stats have given policymakers reason to scratch their heads and look for answers. One feature of the federal student loan program is that almost any student can borrow money for college. There are no underwriting standards to speak of, and some lawmakers have called for restricting who can borrow money for college. Opponents of these efforts say the current system gives every student, regardless of background, the opportunity to obtain a

Editorial: Should the Feds Restrict Who Can Borrow Money for College?

degree and join the middle class. Who is right?

New research shows that the spike in the delinquency rate on loans in recent years was caused in large part by poor students who were unprepared for school and who attended schools that offered slim chances of obtaining employment that would allow students to repay their loans. The research attributes the rise in borrowing and defaults to "non-traditional students" enrolled at for-profit colleges and community colleges, where there are low or no admission standards. Of the students who left school in 2011, the research found that these "non-traditional students" made up over two-thirds of the defaults.

Other research from the Federal Reserve shows that 30% of students with weak credit scores (below 600) during their final year of school eventually became delinquent on their loans, as opposed to just 9% for students with a credit score from 680 - 730.

The idea of using a student's credit score to determine if they should be able to borrow seems problematic. Carefully considering which schools should be able to receive federal student loan money does seem like a logical step, and the Obama administration has already implemented efforts to protect students from schools that frequently do not produce good results for students and whose students disproportionately default on their loans. Many of these schools are for-profit colleges that enroll about 11% of students in higher education, but whose former students account for roughly 44% of all defaults on federal student loans. **In mid-2015, regulations were finalized such that schools now have to show that a typical graduate's estimated annual loan payment does not exceed 20% of his or her discretionary income, or 8% of his or her total earnings**. Programs that go over these levels risk losing federal funding, which makes up 90% of revenue at for-profit institutions, according to the Department of Education. <u>Roughly 1,400 programs serving 840,000 students do not pass these accountability standards today, and roughly 99% of these students are at for-profit colleges</u>.

These so-called "gainful employment" standards were called an assault on the for-profit education industry, but there has already been tremendous pressure on the industry for the past 3-4 years. Corinthian College filed for bankruptcy last year. The University of Phoenix has closed 115 campuses since 2011 after seeing its enrollment drop from 460,000 in 2010 to roughly 200,000. Enrollment across all for-profit colleges is down 20% since 2010. It is too early to tell if these regulations will have a meaningful downward effect on student loan default rates, but keeping students from enrolling in schools and degree programs that have produced poor results should help.

A final pair of interesting statistics: the average amount owed by those who default is just $9,000. This is because so many students drop out after one or two years. Because of this, some economists and lawmakers have proposed lending only to students who meet minimum test score and grade-point average requirements. Others have suggested giving grants to some students to cover their first year of school to see if they can handle college-level work, then offer loans to students only after they demonstrate success in their first year in college.

It remains to be seen if more action toward reducing default rates is taken, but a potential hindrance to further action in this area is that, despite increasing default rates, the federal student loan program generated a $41.3 billion profit in fiscal year 2013. Overall, the program is expected to generate $149 billion in profit over the next 11 years. In the upcoming election season, politicians may judge the default problem to be less important than other issues like fixing Social Security and getting the economy growing at a more rapid pace.

Comments? Send e-mail to Brad@R1FinancialGroup.com.

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