Investor Insights and Outlook

VOLUME 3, ISSUE 2

FEBRUARY 2012

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.

Inside this issue:

A Quick Guide to Lagging Economic Indicators	2
TIPS to Inflation Proof Your Portfolio	3
Investing in Bond Funds	3
Are Bonds Adding to Your Equity Exposure?	4

Advisor Corner

360-457-6000

Thank you for the opportunity to serve as your advisor.

James D. Hallett, MSFP CFP AIFA
jim@hallettadvisors.us

Hallett & Associates, P.S. is registered as an investment advisor with the SEC and only transacts business in states where it is properly registered or excluded from registration requirements.

A Quick Guide to Lagging Economic Indicators

Lagging indicators are economic indicators that lag behind the overall pace of the economy, and can confirm or deny the trend shown by leading indicators. Examples of lagging indicators include the average duration of unemployment, average prime rate, inventory-to-sales ratio, and the change in the Consumer Price Index.

The average duration of unemployment measures the average number of weeks an unemployed individual has been out of work, and is inverted to indicate a lower reading during a recession and a higher reading during an expansion of the economy. This statistic is measured by the Bureau of Labor Statistics on a monthly basis, and is seasonally adjusted to reflect the impact of predictable seasonable patterns. For example, retail businesses tend to hire more part-time employees during the holiday season. This is a lagging indicator because during an economic recovery, real wages increase first, followed by hours worked, and finally by an increase in hiring. This indicator is a good gauge for the overall business confidence sentiment.

The Consumer Price Index is released midmonth and measures the average rate of change month-to-month in the prices paid by consumers for a broad basket of consumer goods and services. This is the most widely-used measure of inflation today and is used as a guide by both Congress and the Federal Reserve to formulate fiscal and monetary policies. More specifically, the Core Consumer Price Index, which excludes the most volatile components of the index like energy and food prices, is used by the Fed to measure whether it is meeting its annual target inflation rate of 1.7% to 2.0%. For example, depressed CPI numbers coupled with high unemployment figures were key factors in the Fed's decision to start buying $600 billion in Treasury bonds to boost investment and consumption rates at the end of 2010. Thus, investors who are interested in investing in government bond ETFs should take note of this indicator (prices of long-term bonds might go up, while yields would fall). This is a lagging indicator because it represents prices that have already changed; announces that inflation arrived—one month ago.

The prime rate is what banks charge their most credit-worthy customers, mainly large corporations. Since Dec. 16, 2008, the Wall Street Journal determines this rate by polling the 10 largest banks in the United States, and will update the published rate when at least 7 of these banks have changed their rates. The prime rate is largely based upon the Federal Funds Rate set by the Federal Open market Committee every 6 weeks. The rule of thumb for the value of the prime rate is 300 basis points (3%) above the current fed funds rate, which is currently between 0% and 0.25%. This is a lagging indicator because the Federal Reserve sets this interest rate in response to economic growth rates, and to stimulate growth, the federal funds rate will be set low for a period after the economy is recovering. This is important to investors because many banks use the prime rate as a basis to price loan products such as student loans, credit cards, and car loans, and is a good indicator if one wants to invest in stocks or ETFs in the financial sector.

The inventory-to-sales ratio is reported by the Department of Commerce and measures how many months it would take to deplete the backlog of goods, adjusted for inflation. An increase in this ratio generally means that sales estimates were missed, and businesses will respond by postponing future orders and cutting production rates, resulting in a slowing economy. Beyond looking at the overall figures published monthly, serious investors should look at the numbers for manufacturers, retailers and merchant wholesalers since each sector has different sensitivities to an economic downturn.

Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than other asset classes.

TIPS to Inflation Proof Your Portfolio

When signs of inflation creep into the economy, investors seek to protect their portfolios by turning to defensive market sectors (utilities, health care). But certain fixed-income investments, like Treasury inflation-protected securities, or TIPS, can be just as useful.

The interest rate does not change over the life of TIPS, but the underlying principal rises and falls with changes in the inflation rate. So the amount an investor will receive as income also changes. At maturity, you either receive the adjusted principal or the original principal, whichever is larger. The table singles out those years since 1990 when inflation was 3.0% (its long-term average) or higher and shows how TIPS fared. Out of the seven years illustrated in the table, TIPS outperformed inflation in five of them—and by a considerable margin.

TIPS Performance During Inflationary Periods 1990—2010

Year	Inflation	TIPS
1990	6.1	23.9
1991	3.1	-13.7
1996	3.3	7.2
2000	3.4	13.2
2004	3.3	8.5
2005	3.4	2.9
2007	4.1	11.8

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.

Are Bonds Adding to Your Equity Exposure?

Investing and poker have been compared on many levels. For starters, poker is a zero-sum game—what the winner wins has to be equal to what the losers lose. But investing is not a zero-sum game because over time stocks tend to have positive returns, making it possible for investors to be overall winners.

Both, however, are games of incomplete information with unknown variables and conditions that cannot be controlled. To offset these uncertainties, it is important for players of both groups to assess and understand their appetite for risk. Doing so develops discipline, a strategy, and may help reduce unexpected setbacks.

The questions below are designed to help shed light on your risk tolerance. The questions are hypothetical in nature and are not meant to represent investment advice. Answers are symbolic of different risk levels: "a" conservative, "b" moderate, and "c" aggressive.

1. I am comfortable with investments that may often experience large declines in value if there is a potential for higher return.
   a. Disagree b. Uncertain c. Agree

2. Suppose you owned a well-diversified portfolio that fell by 20% over a short period of time. Assuming you have 10 years until you begin withdrawals from your account, how would you react?
   a. I would immediately change to a more conservative portfolio. b. I would wait at least 6 months to one year before changing to more conservative options. c. I would not change my portfolio.

3. Which statement best describes your investment goals?
   a. Protect the value of my account by minimizing loss and accepting lower long-term returns. b. Balance moderate levels of risk with moderate levels of returns. c. Maximize long term returns and accept large or dramatic swings in the value of my investments.

4. Portfolios with the highest average returns also tend to have the highest chance of short-term losses. The data below represents five hypothetical investments of $100,000 over a one year time frame. Which range would you feel most comfortable with?
   a. Portfolio A: $139,000 – $88,800 b. Portfolio B: $179,000 – $75,700 c. Portfolio C:$215,000 – $59,500

Now, keep in mind that these are only guidelines meant to give you insight into how you think and behave as an investor. Once you have discovered that you are, let's say, aggressive, this certainly doesn't mean that you now have to invest in high risk stocks and emerging markets for the rest of your life. On the contrary, your risk tolerance may change over time, and revisiting these questions periodically may let you know if it's time to change your investment strategy.

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

James D. Hallett, MSFP, CFP®, ChFC, CLU, CDFA™, AIFA®

321 E First Street
P.O. Box 3050
Port Angeles, WA 98362

www.HallettAdvisors.us
jim@hallettadvisors.us
Tel: 360-457-6000

©2011 Morningstar, Inc. All Rights Reserved. The information contained herein (1) is intended solely for informational purposes; (2) is proprietary to Morningstar and/or the content providers; (3) is not warranted to be accurate, complete, or timely; and (4) does not constitute investment advice of any kind. Neither Morningstar nor the content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. "Morningstar" and the Morningstar logo are registered trademarks of Morningstar, Inc.