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COROMANDEL WEALTH MANAGEMENT

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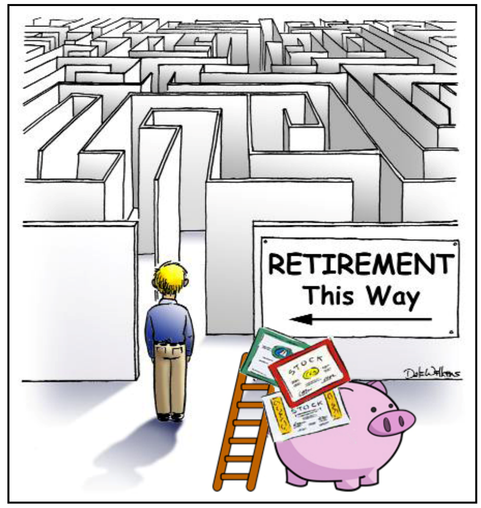
Save Money by Building Your Own "Bond Ladder"

Navigating the Retirement Maze



Predictable income streams are a crucial component of retirement income planning. This is why fixed income instruments such as bonds, CDs, and annuities are an essential component of most retirement portfolios. In past years, one could depend upon decent yields from CDs and Treasuries, but the Federal Reserve's manipulation of interest rates has resulted in anemic current rates of return. Thus, retirees are forced to look elsewhere for higher yields, with correspondingly higher risks.

Investment-grade corporate bonds are a good risk-return compromise. They pay yields 1% to 2% higher than Treasuries or CDs of similar maturities and are issued by companies that are financially solid, and therefore have a low risk of default. However, there is still some risk. Long-maturity bonds (5-30 years), while delivering higher rates of return than shorter maturities, lock you into these rates for a long time. An eventual increase in inflation can leave you stuck with yields that have you losing purchasing power every year until your bonds mature.

So how do you get better current income without this interest rate exposure? One technique is called "bond laddering", and a new class of exchange traded funds (ETFs) makes this an easy and inexpensive proposition.

Build Yourself a "Ladder"

The concept of a "bond ladder" is simple: you purchase equal allocations of bonds of increasing maturities. Each set of bonds at successive maturity dates forms a "rung" of your "ladder". For example, use one-tenth of your income-targeted assets to buy bonds that mature in one year, one-tenth for 2-year bonds, and so on up to ten-year bonds. You'll end up with a total yield that is between that of one and ten year bonds, but without the rate risk you would have if you had purchased only 10-year bonds. As each bond matures, you roll the proceeds over into a new 10-year bond. This way, if interest rates start to increase – and trust me, they will – you will capture the new higher 10-year rates with each newly issued bond.

The Hidden Cost of Buying Bonds

The average investor typically isn't comfortable purchasing individual bonds on their own – they don't know a CUSIP from a Moody's rating – and many rely on full service brokers to purchase their bonds. The absence of an explicit fee on the brokerage statement may make it appear as though the bonds are commission-free. However, brokerages typically mark up the price of a bond sold out of their inventory anywhere from 1 to 5 percent – the difference between what they paid for the bond, and what they sold it to you for, also called the "spread". So if a newly purchased bond yields 2.5%, you may have just paid several years' worth of income on the spread.

Fixed Maturity Bond ETFs

In the past two years, a new type of ETF has been created that enables "do-it-yourself" bond laddering. Guggenheim Funds and BlackRock have issued ETFs that contain only bonds maturing in a specific year: 2013, 2014, and so on. Want to build an 8-year bond ladder? Buy each of the sequential ETFs in equal amounts. Purchasing $100,000 worth of these bond ETFs through a discount brokerage will cost you on the order of $60, a far cry from the $3,000 that you might have indirectly paid to a full-service broker. While there is an annual expense fee for these ETFs (0.24% and 0.4%, respectively), you'll end up paying less overall while getting the benefit of a diversified bond portfolio.

For Serious DIY Investors

Most discount brokerage sites are making it easier for investors to purchase individual bonds, so for a little effort, you can assemble your own investment grade bond ladder. Pick your desired maturity date and credit quality, and a list of bonds satisfying those criteria will appear. Like the idea of AAA-rated Microsoft bonds maturing in 2019 and paying 1.63%? You can purchase $50,000 worth of these bonds for about a $50 commission. Need some help? While they can't give you specific investment advice, most discount brokerages can assist you with the selection process.

There are many options available today for purchasing fixed income instruments that won't cost you an arm and a leg, or a year's worth of interest. As always, do your homework to make sure that you understand what you are buying, and you'll be rewarded with predictable income streams at considerable savings to you.

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