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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

Recession fears notwithstanding, total earnings for the S&P 500 this year is expected to rise 14.2% relative to 2010.

The Intrade prediction market assigns a two thirds chance that Mitt Romney will be the Republican nominee in 2012. The same market assigns a one in seven chance for Rick Perry.

Bond Funds with Fixed Maturity Dates

Bonds are typically regarded as a refuge from tumultuous markets. Yet varying interest rates and credit spreads can still cause price movements in fixed income portfolios. Investors with limited time horizons typically buy individual bonds or short maturity bond funds to lock in returns over brief periods. Individual bonds tend to be illiquid and subject their owners to default risk. Short term yields are so low now that they are almost indistinguishable from keeping money in a mattress. Is there an alternative?

Last year, Guggenheim and Ishares began offering target date exchange-traded funds (ETFs) in an effort to address investors with shorter term investment horizons. The unique element about each fund is that they have a preset expiration date. All the bonds in each fund either mature or are callable in the same calendar year and the final distribution is paid at year end, If an investor has a financial liability such as a tuition payment due at a certain time, these target date maturity funds might fill the bill.

The fees are reasonable which are typical of the ETF structure. For example, Guggenheim's corporate bond ETFs have management fees of 0.40% or less. Ishares municipal bond funds have expenses of 0.30%.

The fact that all the bonds mature at about the same time provides the investor some measure of certainty. Changes in market interest rates and credit spreads will still affect the price of the funds as they approach the maturity date. However, that volatility should dissipate as the redemption year approaches. At year's end, the funds from all the bond maturations are paid out to the investor and the ETF goes away. Interest payments from the bonds are passed on the investor at regular intervals leading up to this point.

The target date ETF thus behaves like a bond in that it pays regular interest until its maturity date at which point it is redeemed at par value. The big benefit is that the retail investor gets the benefit of diversification in many bonds. A single default will not sabotage the portfolio.

Do target funds guarantee a return over a specified time horizon? Not really – but close.

These funds hold somewhere from 60 to 140 bonds. Some of these may default prior to maturity and this will impair the return. Some bonds may be called away by the issuer earlier and this adversely affects the anticipated return. The good news is that the default rate on municipal and investment grade corporate bonds has historically been low. There is strength in the large number of bonds in these target date funds. Even junk bonds offer a yield premium that can offset reasonable numbers of defaults.

What kind of return can an investor expect if the default experience within the fund is minimal? It is not the current yield or "SEC yield" that you see routinely quoted in Morningstar or other trade source. This current yield, briefly, is the average coupon divided by the average bond price.

The return that the investor is likely to realize in is known as the "yield to maturity" This measure adjusts the current yield by the scheduled amortization or accretion of bond prices in the portfolio. If the average price of a bond in the portfolio is less than par, the yield to maturity is higher than the current yield. Conversely, bonds trading at a premium to par will generate a yield to maturity that is less than current yield.

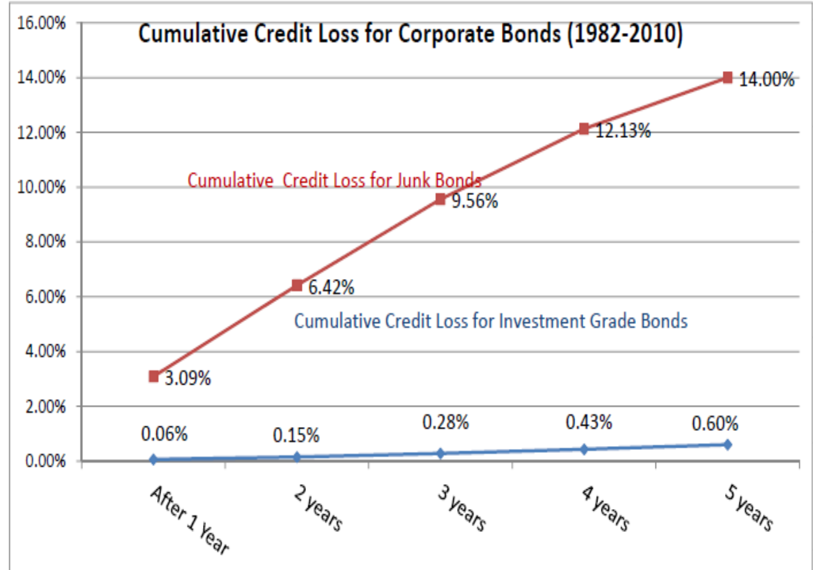
There can be a considerable difference between the *current yield* and *yield to maturity*. In practice, the realized return will be somewhat less due to calls and defaults – both of which are more prevalent with high yield bonds than investment grade bonds.

With today's interest rates at historically low levels, corporate bonds are trading at a significant premium to par (or redemption) value. They may pay a substantial current yield but when the loss of principal over time is factored in, their yield to maturity is less. Yield to maturity is not a required disclosure among bond mutual funds but is an important consideration to those thinking about a fund with a fixed maturity.

What kind of losses can be expected due to defaults? It is difficult to predict as this experience varies considerably with the economic cycle. Right now, the default rates are low but were considerably higher in 2002 and 2008 when corporate earnings plummeted. The good news is that even bonds in default have some salvage value. Typically, that value is 40 to 65 cents on the dollar. A better measure of impairment

due to defaults reflects not only default history but the level of salvage value from impaired bonds.

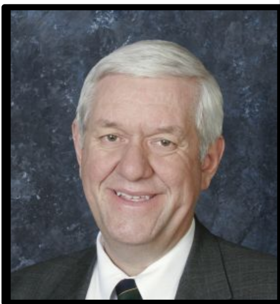
The table below at right reflects the cumulative losses from both investment grade and junk bonds since 1982. This period includes a few recessions as well as long term economic expansions. Bottom line is that losses due to junk bond defaults are roughly 3.0% annually and losses in the investment grade space are pretty negligible. This kind of investment is worth a look for individuals with well defined future financial obligations.



"Losses due to junk bond defaults are roughly 3.0% annually and losses in the investment grade space are pretty negligible.'

Guest Column: Prioritizing Pre-Nups

You do not have to be a celebrity or a movie star to consider a prenuptial agreement or "pre-nup". There are numerous reasons for a couple who marries at any age to consider a pre-nup. The adage "Good fences make good neighbors" is especially true with a national divorce rate that has hovered at 50%.



Young adults can use a pre-nup to shield themselves from a partner's debt accumulated before the marriage, such as credit cards, car loans and student loans. They also can insure that family money stays in the family and can be passed down to the next generation. A pre-nup also encourages young adults to have an open and honest discussion of their finances which, quite frankly, receive less thought and conversation than the honeymoon destination. More significantly, it encourages the couple to discuss their individual beliefs and concepts of money and debt.

Couples who marry or remarry in their later years or who have children from a prior relationship should definitely consider a pre-nup. A pre-nup can ensure that children from a prior marriage or other family members receive an inheritance or family business instead of the entire estate going to the new spouse. At our law firm we often draft Wills and Living Trusts that even *require* the surviving spouse to obtain a pre-nup prior to remarriage after the first death, which can provide the survivor with an "excuse" to get one. Our experience shows that adult children often see a new spouse as a threat to the inheritance. Completing a pre-nup gives these same children a greater sense of security, and helps open their hearts and minds to the new spouse. It can also protect pensions and retirement benefits if the marriage does not last. In many respects, a pre-nup can be used as a financial planning tool, and a well drafted one can make the administration of an estate substantially easier and less expensive. The role of pre-nups in a marriage later in life cannot be over stated.

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