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Diversify your bond portfolio with laddering

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Diversification isn't just for stock investors. Bond investors should avoid putting all of their eggs in a single basket, too. A bond ladder can be an effective way to reduce your bond portfolio's risk.

Diversification basics

You can diversify your fixed-income portfolio in many ways — with U.S. Treasuries and corporate bonds, domestic bonds paired with foreign bonds, or high-quality securities coupled with lower-rated, higher-yielding holdings, to name a few possibilities.

Another way to diversify your bond portfolio is by maturity date — the point at which issuers must pay back the principal on their debt. One way to diversify by maturity is through bond laddering. Bond laddering can provide a consistent level of income while minimizing your portfolio's overall interest rate risk.

Climbing down the ladder

Here's a simple example of a bond ladder in action. Let's say you buy a series of five bonds with maturity dates of two, four, six, eight and 10 years, respectively, giving your portfolio a six-year average maturity.

This average maturity will decline over time as your bonds near their maturity dates. In other words, two years from now, your shortest bond will have matured, and you'll be left with four other bonds maturing in two, four, six and eight years, respectively. By buying a new 10-year bond, you can preserve your portfolio's six-year average maturity. To maintain your ladder, just repeat this process every two years.

If interest rates have risen during the previous two years, the older bonds in your portfolio will likely have declined in value. However, the newly purchased bond will offer the higher prevailing yields, partially countering this negative performance impact. Of course, the opposite is true, too. If

interest rates have recently fallen, your new longer-maturity bond probably will be yielding less than your older bonds issued in earlier, higher-rate market conditions.

Generally, the longer a bond has until it matures, the more vulnerable it will be to rising interest rates. Therefore, the longest bonds in your ladder normally will be hurt the most when rates go up, while your shortest holdings will be less affected.

However, beware that market conditions in recent years have caused the traditional yield curve, under which longer term bonds pay a higher rate of interest, to flatten out. As a result, some investment managers have re-evaluated and often shortened the traditional bond ladders that they create or maintain.

Funds use ladders, too

To maintain an effective bond ladder, it's necessary to buy a number of individual bonds, requiring a significant initial cash outlay. This is especially true for large portfolios. Also bear in mind that the example above is highly simplified. In practice, maintaining an effective bond ladder can require significant ongoing management.

An alternative way to obtain the risk-reduction benefits of laddering may be to buy a bond mutual fund. Mutual funds generally own a large number of bonds and therefore provide built-in diversification, even for small investment amounts.

Risk still exists

Keep in mind that bond ladders can help you reduce interest rate risk, but they won't eliminate it completely. If you're concerned about risk in your bond portfolio, ask your financial advisor about implementing additional diversification strategies.

Mutual funds are sold by prospectus. Investors should carefully read the prospectus before investing. They also should carefully consider information contained in the prospectus, including investment objectives, risks, changes

and expenses, before investing. For this and other information, request a prospectus from your financial professional.