Personal Finance

Fixed income investing in volatile markets

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Within the past decade there has been unprecedented movement in the equity and fixed-income markets. In dynamic economic times even novice investors are gratified by their investment returns. Often, however, when investment results are sustained for a period of time, a grave misconception of possessing investment expertise, as opposed to riding the market, may result in a rude awakening. Investment expertise takes time to develop, it involves planning, the establishment of goals, working within a time horizon and having a total comprehension of risk tolerance.

Locking into an attractive rate of return a few years ago may have appeared to be the right thing to do, at the time. After all, no one has the ability to foresee precise future interest rate movements. Many investors enjoyed a good rate of return on a fixed-income security that has recently matured leaving them with the dilemma of placing cash from the maturity into a much lower paying instrument. So how does one compensate for unexpected market movements and at the same time maximize investment return?

Although there are many fundamental investment theories which would prove satisfactory in certain investment situations, there is one elementary principle which many investment advisors subscribe to which has been proven effective, uncomplicated and a sure fire investment approach in many professionally managed portfolios.

This fundamental approach is called, "laddering."

LADDERING

Laddering is the simple process of dividing fixed income investable funds into investment blocks and then subjecting those blocks to an investment philosophy. The overall asset allocation philosophy might be classified as fixed-income, with growth, wherein 80% of the total portfolio is allocated to fixed-income and 20% committed to good quality blue chip stocks or mutual funds with clearly defined investment objectives. Establishing an investment plan can be architecturally done professionally (the preferred method) or by yourself. However, the entire process demands considerable time, proper asset allocation modeling and calculations to determine the most effective path for you to pursue. Let's assume you have properly created such a plan. Perhaps, your investment portfolio ratio has been established to be 80% in fixed-income securities and 20% in high quality equity (stock) mutual funds for a portfolio totaling $100,000.00 of investable funds. The laddered approach to this investment portfolio would be as follows: Fixed Income Securities

Assuming 80% of the portfolio would be invested in fixed-income securities, your first task is to divide 80% of your investment portfolio by four (this number will vary upon the size of the portfolio, liquidity needs, and the amount predetermined to be invested in fixed-income securities. In this case $80,000.00 (80% of the $100,000.00 investable portfolio) will be divided by four to equal the laddered amount of four $20,000.00 blocks. The number and size of your blocks will be determined by your model. There are now five parts to the total investment portfolio — four $20,000.00 fixed-income security blocks and a balance allocated to equities. The next step is to ladder the four $20,000.00 blocks by deciding what type of investment to purchase for each block. If Certificates of Deposit are the choice, then the approach should be to buy a $20,000.00 certificate maturing in one year; a $20,000 certificate maturing in two years; a $20,000.00 certificate maturing in three years and $20,000.00 certificate maturing in four years. This approach, more or less, will avail your investments to the upward and downward trends in the interest rate market by having 25% of the fixed-income investment portfolio mature on an annual basis with a reinvestment of those funds into current interest rates for a specific number of years. You can now see the advantage of laddered maturities wherein this approach capitalizes on the volatility of the interest rate market. Contrary to this approach, is to have 80% of the investable portfolio maturing in one year, a year in which interest rates might be at an all time low. Then the question becomes, "Where do you invest the proceeds from the maturities?" This could be a very frustrating experience, especially if you are dependent on the income generated by your portfolio.

The laddered approach will assure a better than average approach to fixed-income security investing, especially in volatile interest rate markets. This application may also be applied to government securities, tax free municipal bonds, corporate bonds and other fixed-rate and term instruments. Equities

The remainder of the portfolio can be used to provide the potential for long-term principal growth. Certainly the intention here is not to involve investors with speculation, specific stock selection and/or a high degree of risk, but suggests an investment into a well diversified list of good quality stocks with an above average dividend yield or mutual funds where the fund's objectives coincide with the investment plan. By taking this approach, the investor has an opportunity for capital appreciation and, at the same time, may enhance the income portion of their portfolio through the receipt of dividend payments and an offset to inflationary trends. A typical laddered, fixed-income, with growth, portfolio would resemble the chart that accompanies this article.

80/20 INVESTMENT PORTFOLIO

Par Shares	Description	Maturity	Rate	Market Value
FIXED INCOME				
$20,000	ABC Bank CD	June 2002	3.00%	20,000
20,000	US Treasury	June 2003	4.00%	20,100
20,000	US Savings Bank CD	June 2004	5.00%	20,000
15,000	Corp. Bond	June 2005	6.00%	15,200
EQUITY				
5,000	Solid Stock Mutual Fund			5,800
5,000	Stable Mutual Fund			5,200
5,000	Large Cap Mutual Fund			5,100
5,000	Blue Chip Index Fund			6,000
MONEY MARKET				
5,000	Dollar Value Money Market Fund		5.03%	5,000
TOTALS				
$100,000				$102,100

(Above securities and corresponding data are fictitious and represents a hypothetical portfolio for explanatory purposes only).

Laddering is an age-old investment approach which is uncomplicated, suitable to any size portfolio and has a proven track record of satisfying some of the most astute investors.