

EDUCATED INVESTOR

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Focusing on Fixed Income

Once upon a time, fixed income investing meant little else besides buying U.S. Treasury bonds or opening up savings accounts. Today, the world of fixed income is much more complex. We are besieged by high-pressure marketing campaigns touting a range of enigmatic alphabet-soup options including MBSs, IOs, POs and more.

Bond experts Larry Swedroe and Joseph Hempen, co-authors of the newly published *Only Guide to a Winning Bond Strategy You'll Ever Need*, explain:

"While the world of fixed-income investing is a very complex one, the winning strategy is actually quite simple."

Here are some simple rules for today's fixed income investor:

- ▲ Purchase assets with short- to intermediate-term maturities. Avoid long-term bonds.
- ▲ Purchase assets from the highest investment grades, generally avoiding instruments with a rating below AA.
- ▲ Avoid the purchase of "hybrid securities" that have characteristics of both equities and fixed income assets. These include convertible bonds, preferred stock and high-yield bonds. In general, avoid fixed income securities with dazzling, complex features — investments generally meant to be sold (by brokers) not bought (by investors).
- ▲ Avoid bonds with high markups by being wary of buying individual bonds from a brokerage firm, commercial bank or investment bank. We feel their hidden markups can be excessive. Similarly, seek bond funds with the lowest expenses.
- ▲ Write and sign an Investment Policy Statement that defines your objectives, risk tolerance, investment strategy and eligible securities.
- ▲ Don't attempt to outperform the market, whether by trying to guess the direction of interest rates or identify mis-priced securities.

Why bother with fixed income investing to begin with? This issue of *The Educated Investor* offers answers to this and other related frequently asked questions.

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To Catch an Identity Thief

It used to be that, to catch a thief, all you needed was a sensitive alarm system and the ability to either outgun or outrun your assailant. In today's electronic environment, identity theft can strike with an invisible hand, with nobody to set off the alarms when it occurs. How does the Federal Trade Commission



recommend you minimize the odds of being the next victim of identity theft?

The Federal Trade Commission's (FTC's) Bureau of Consumer Protection is the government agency responsible for

assisting citizens in these efforts. As such, the FTC's Web site seems an excellent source to learn more:

<http://www.consumer.gov/idtheft/>

For example, the FTC offers a printed or electronic publication entitled "ID Theft: What It's All About." This handy publication provides specific, useful

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Focusing on Fixed Income (Cont.)

Following are some of the frequently asked questions we typically receive from investors who want to know more about the fixed income component of their portfolios.

Q: Why does fixed income matter?

A: Many investors are driven by one investment goal — portfolio growth to support their financial needs. So, too often, stocks (equities) get the majority of an investor's attention, while fixed income becomes an afterthought.

In reality, both components play critical roles in a prudent investment strategy. While equity is best used to capture expected returns commensurate with the risk being taken, fixed income is meant to bring overall portfolio risk to an appropriate level and/or create a reliable income stream.

In other words, fixed income is a multi-tasker. First, it can mitigate the impact of equity risk, thereby reducing risk for the overall portfolio. To generate reliable income from equity, your portfolio should be built to weather all kinds of adversity like bear markets, recessions and global events. Combining fixed income and equity brings important balance that an all-stock portfolio doesn't have.

Second, bond or bond fund interest can provide a more reliable source of cash flow to help meet life's expenses. Most bonds bear interest that they are contractually obligated to pay on a regular basis for the life of the bond. This is generally more consistent than equities' dividends and capital appreciation, neither of which are as certain.

Q: How has today's fixed income investing world become much more complex?

While equity is best used to capture expected returns commensurate with the risk being taken, fixed income is meant to bring overall portfolio risk to an appropriate level and/or create a reliable income stream.

A: There are so many more fixed income choices these days, and they each tend to have distinct, specialized features. The advantage is more options tailored to address differing investment needs. The disadvantage is that more features add more complexity. Think about the home mortgage industry. Today, it's not just 30-year fixed rate mortgages available. Home buyers face overwhelming lending choices, and often struggle to understand which is right for them. It's the same with fixed income.

Q: So, what is the fixed income investor to do amidst the complexity?

A: In a nutshell, we advise — and the historical evidence demonstrates — that the most appropriate vehicles for the fixed income portion of the portfolio are generally short- to intermediate-term bonds of the highest investment grades of AA or better (or bond funds holding such bonds).

Q: Why short- to intermediate-term?

A: The long answer involves a discussion of the bond yield curve. The short answer is: long-term bonds are generally less appropriate than short- or intermediate-term bonds, because they cause the investor to take increased risk for comparatively little expected reward.

Q: Speaking of the “bond yield curve,” why all the recent discussion about it in the press?

A: You may have noticed that the bond yield curve has been receiving a lot of media coverage lately because of its unusual flatness. That is, bonds of all maturities are currently delivering unusually similar yields. While nobody can predict what the future holds, the prudent investor ignores short-term trends that often fascinate the popular press, and focuses instead on carefully planned, long-term investment objectives.

Q: Why only the highest investment grades?

A: Because of the risk reduction role fixed income plays, it is appropriate to be more concerned about the return of your fixed income principal than the return on your fixed income principal. By purchasing lower grade bonds seeking to increase overall return, you also increase your odds that the bond might default and cause you to lose your initial principal investment.

This risk is in direct opposition to the role that we think fixed income investing

should play. If an important goal is to increase returns, our suggestion would be to either (1) increase your allocation to equities where you can take on the risk more efficiently (with greater opportunities for tax management and diversification) and/or (2) increase your exposure to riskier small-cap and/or value equities.

Q: What are hybrid securities? Why avoid them?

A: Hybrid securities have characteristics of both stocks and bonds. For example, preferred stocks, convertible bonds and junk bonds are all hybrids.

There are a number of reasons we would advise you avoid hybrids. While a detailed discussion is beyond the scope of this newsletter, it can be found in the aforementioned *Only Guide to a Winning Bond Strategy You'll Ever Need*. To summarize, many of our concerns center around the fact that a hybrid is, by definition, neither fish nor fowl (neither equity nor fixed income).

As a result, the investor can too easily lose control over how to appropriately diversify the holding's risk characteristics and manage it within an overall carefully structured portfolio. As one example, it is generally most tax efficient to locate stocks within taxable accounts and fixed income within tax-advantaged accounts. With a hybrid, the investor must hold one or the other in its less desirable location.

Q: How are bonds typically bought and sold (and why should I care)?

A: While equities are traded on a centralized exchange and carry publicly transparent prices, bonds are traded on what is called an over-the-counter market, a loose confederation of dealers around the country. This

means, right now, you can open a newspaper or check the Internet and find the last traded price of almost any stock of interest. You can't do that for bonds; pricing is largely invisible to the general public. This makes it harder to comparison shop to determine a bond's fair value, shifting the advantage away from you and toward the professional trader.

Q: Why should I avoid buying or selling bonds at a brokerage firm or bank?

A: First, because of the aforementioned lack of transparency, you may unknowingly pay excessive price markups. You may think your only cost is the ticket charge. But often, the price you pay (for buying) or receive (for selling) is significantly worse than the price the brokerage firm is obtaining.

Second, sometimes the brokerage firm only offers you bonds that it has in inventory at the time. There may well be more appropriate bonds with specific features that would better suit your financial goals. But the broker's priority may instead be to use its own inventory rather than ensure it has met your best interests.

Q: So, how should I incorporate fixed income?

A: First, start with a plan in the form of a written Investment Policy Statement (IPS). Your IPS should reflect your unique financial goals as well as how much risk you are willing and able to take to achieve them. Seek the assistance of a qualified professional who can help you form your IPS; construct a globally diversified portfolio suitably allocated between the fixed income and equity asset classes; and maintain that portfolio via disciplined rebalancing.

Second, be aware of the obligations of those with whom you choose to entrust your financial well-being. A brokerage firm is only obligated to meet what are known as "suitability standards" — ensuring that products or services they provide are suitable. A fee-only, Registered Investment Advisor (RIA) firm must additionally meet a higher standard known as "fiduciary obligation."

As such, we are required to act with utmost good faith in your best interests. For example, if we are aware of two comparable and suitable options and one costs less, we are obligated to recommend the lower cost one on your behalf, while a brokerage firm may not be. Particularly if you are seeking a customized individual bond portfolio, a trusted RIA firm ally can help you avoid excessive broker markups that can detract from your otherwise carefully built goals.

We advise — and the historical evidence demonstrates — that the most appropriate vehicles for the fixed income portion of the portfolio are generally short- to intermediate-term bonds of the highest investment grades of AA or better (or bond funds holding such bonds).

To Catch an Identity Thief (Cont.)

guidance on the following topics:

- ▲ How identity theft occurs
- ▲ How to tell if you're a victim (including obtaining your free annual credit report)
- ▲ How to protect your personal information (including Social Security number)
- ▲ How to proceed if theft has occurred (immediate and long-term)

The direct electronic link to this publication is as follows (or you can contact the FTC at 1.877.438.4338 to obtain a hardcopy):

<http://www.ftc.gov/bcp/online/pubs/credit/idtheftmini.pdf>

How concerned should you be about identity theft? For the five-year period 2001–2005, the FTC has reported signifi-

cant annual increases in the approximate number of identity theft complaints, with incidents steadily growing from 86,000 in 2001 to 255,000 in 2005.

While even the most cautious individual or institution is never wholly immune to the threat, taking an ounce of time to review available information from the FTC might offer a pound of prevention.

How the Fixed Income Markets Really Work

Hailed by author and columnist Jane Bryant Quinn as “The Bond book for our time,” this recently released book by Larry Swedroe and Joseph Hempen addresses all of the lessons discussed in this issue of *The Educated Investor* and more.

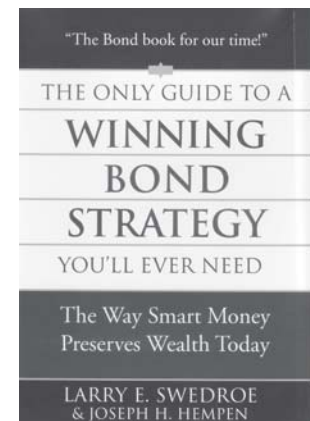
With approachable, story-telling readability, the book explains how to:

- ▲ Understand the characteristics of today's fixed income investments — including potential risks and rewards
- ▲ Adopt a practical road map to a prudent fixed income strategy
- ▲ Select investment vehicles that are appropriate for you

Worth Repeating Worth Repeating

“ If your portfolio was a stew, fixed-income securities would be a main ingredient, like potatoes or carrots, not just a seasoning (e.g., salt, pepper) you add but might be able to leave out without adversely affecting the quality of the stew. ”

— Larry Swedroe and Joseph Hempen
*The Only Guide to a Winning Bond Strategy
You'll Ever Need*



Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- ▲ Fee-only investment management
- ▲ A disciplined investment strategy
- ▲ Access to institutional no-load passive asset class funds
- ▲ Fixed income expertise

- ▲ An academic Nobel Prize-winning investment approach
- ▲ Continued access to academic research
- ▲ A tax-efficient focus, with valuable tax and estate-planning ideas
- ▲ Risk tolerance assessment
- ▲ Periodic portfolio rebalancing
- ▲ Regular communications and state-of-the-art reporting
- ▲ **MOST IMPORTANT ...
A TRUSTED ADVISOR RELATIONSHIP**