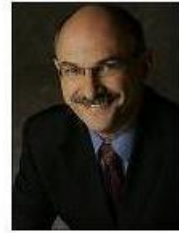


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FINANCIAL MANAGEMENT



The Birds, the Bees and the...Bonds?

Very often, parents uncannily *just know* when the time is right to have that “talk” with their kids about the birds and the bees.

Well... I have an uncanny feeling that the time is now upon us to have that same “talk” about bonds.

So let’s talk, shall we?

Bond Basics

Before we begin... a few bond basics would be helpful to get you started. Very simply, a bond is a contractual arrangement where one party lends money to another, at a fixed rate of interest, and a mutually-agreed schedule for payments of interest and the loaned amount.

Trillions of dollars of bonds are traded every day in an active secondary market. Market liquidity is aided by the fact that bonds are easier to price than stocks.

The price of a bond depends on three important factors:

- 1) the maturity date by which the loan must be fully repaid with interest;
- 2) the stated interest rate; and
- 3) the quality of the bond, which reflects the borrower’s ability to pay back the principal and interest.

Bond Pricing

Say I paid \$10,000 for a bond one year back in 2009. My bond has a loan amount of \$10,000, matures in 2020, and pays 3% interest (or \$300 annually).

Now, in 2010, you come along wanting to buy a bond and find that the same issuer offers a bond for \$10,000 - with the same \$10,000 principal, the same 2020 maturity, but with 6% interest that pays \$600 annually.

You, as a bond buyer, would of course prefer the newer issue that pays you \$600 annually.

Now, if I want to sell, I would have to drop the price on my bond to \$5,000 so you could buy two of my bonds for a total of \$10,000 and get two interest payments of \$300 each, or \$600 in total. You'd be indifferent between buying two of my bonds or one of the new bonds, because either would get you \$600 annually on your \$10,000 investment.

The lesson here is that as interest rates rose, the bond price in this example fell. Proof that bond holders too can lose money.

Interest Rate Risk

Let's look at the most popular bond fund in the world - the PIMCO Total Return Fund with \$256 billion under management and a yield of roughly 3%.

Between November 4th and November 15th, interest rates rose causing the price of this fund to fall from \$11.77 to \$11.51 per share - a decline of \$0.26 or 2.2%. Had you bought this fund on November 4th, your expected annual yield from income of 3% would have been offset by a loss of principal value of 2.2%, leaving you with 0.8% (if the fund stayed at that price for the rest of the year) or only a third of your expected yield for the entire year. Quite a let down!

Similarly, from November 4th to November 18th, the price of the 30-year US Treasury Bond dropped from a high of 99 cents on-the-dollar to 93 cents on-the-dollar, down 6% in just two weeks.

This significant drop in yield was not due to any mismanagement on PIMCO's part, but a direct result of an increase in interest rates that week, which immediately impacted bond prices across the board.

Bond Investors Take Note

As I've said (some say "harped on") before, over the past year many investors have closed their stock positions and moved all their money into bonds, thinking bonds are safer. Well, hopefully now you see that bonds too can carry significant risk which may result in sizable loss of capital.

I don't want to scare you away from bonds. They are an important element of most portfolios. I just want you to be aware of the risks and rewards so you don't overly load-up on any one type of investment and continually strive for balance.

All investments have risks and rewards and it's up to you to accept or reject them with the knowledge you have gained.

Last week's "wake-up" call means it is time to focus on your bond investments and time to brush up on the birds and the bees and the....bonds.

Well, I think our "talk" is now done. You can get back to whatever you were doing.