THE EDUCATED INVESTOR

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Building Bond Portfolios

You may have heard of (perhaps even already hold some) municipal bonds, or "munis." But how familiar with them are you really? Can a managed muni bond portfolio add value to your investments?

Why Munis?

As with any fixed income investment, munis should be your strategy for meeting these primary fixed-income objectives:

1. To balance the risks you are taking in the equity portion of your portfolio
2. To serve as an ongoing source for reliable income

A properly constructed muni portfolio enables you to meet the risk-reduction and reliable income objectives for fixed-income holdings … *plus* you can enhance expected after-tax returns on fixed income you are holding in your taxable accounts.

Attention to Details

But not even all munis are created equal. Of course one must determine the yield, or return, that a bond offers (noting that the yield of a bond is not its stated interest rate unless you are purchasing at par). But the yield alone reveals little about whether the bond is right for you. We apply our expertise to help you select and maintain a balanced, well-structured bond portfolio that meets your individual objectives. Following are just some of the details we analyze:

- **Investment Grade/Credit Rating** — We recommend only high-grade bonds, at or above predefined credit ratings (also known as "investment grade"). Lower-grade bonds force you to accept added risk that fails to meet the primary objectives for fixed-income investing.

- **Maturity and Callability** — All bonds have maturity or due dates. Each bond also has specifications about if or when it can be "called" (cashed in) by the issuer prior to maturity. Because calls typically occur when the economy is down and interest rates have fallen, you risk losing higher-yielding callable bonds just when they will be hardest to replace.

- **Portfolio Construction** — Ultimately, your bonds should fit into an overall configuration that meets your needs and risk tolerance. Typical constructions are the "ladder" to ensure a regular stream of income, or the "bullet" to yield lump sums at future dates. It again becomes important to be aware of each bond's call features. Otherwise, unanticipated calls may wreak serious damage on otherwise well-intentioned plans.

- **Yield Curve Placement** — Within the same bond issue, investors can select maturities ranging from a year to multiple decades. Its return relative to maturity forms a bond's "yield curve." Relative to the risk of potential price fluctuations at both ends of the curve, buying too short in the curve means you must compete against the high demand for short-term holdings, resulting in lower returns. Buying too long in the curve may not adequately compensate you for the length of your commitment. We recommend bonds that fall in a five- to nine-year maturity "sweet spot," neither too short nor too long.

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Test your familiarity with the municipal bond market.

1. What is the limit that regulators place on the potential markup that brokers can add to a municipal bond's price?

   a. 0.25 percent of the bond price
   b. 5 percent of the bond price
   c. No limits

2. We consider it an advantage for your bond broker to maintain an in-house inventory from which to sell bonds to you.

   a. True
   b. False

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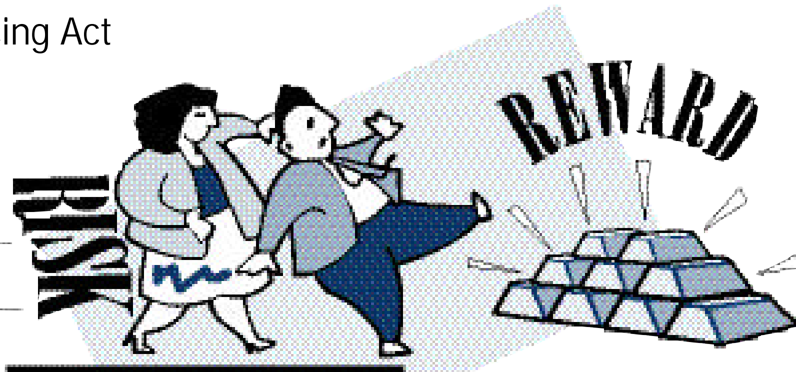
What's Inside?

- Balancing Act
- The Best and Brightest College Tuition Plans

Balancing Act



Fixed income holdings help dampen the risk of your overall portfolio – to serve as your "safety net" when investment times are tough. But purchasing equity (stock) holdings is equally vital to the long-term well-being of your investments. After all, a safety net is supposed to allow you to take a bit more risk.

Of course rewards that you can expect from equity investing are not without their risks.

1. The stock market is inherently riskier than fixed income investing.
2. Various stock asset classes carry different levels of risks — large-cap is less risky than small-cap, and growth ("glamour") is less risky than value (distressed).
3. Each company's stock holds some risk. As we saw recently with Enron, even investing in a company that appears rock solid bears some risk.

In addition to holding fixed income, another way to control your portfolio's risk is by **diversifying** your equity holdings. Effective diversification can reduce the volatility of your portfolio without reducing expected returns. The risk of individual stock ownership can be diversified away in a low-cost, tax-efficient manner by owning passive asset class, index or exchange traded funds that basically own all the stocks in the asset class/index. The risks of individual asset classes can be managed by building a globally diversified portfolio and allocating funds across all the asset classes.

Given the benefits of diversification, how many investors actually take full advantage of it? A study by William N. Goetzmann and Alok Kumar, "Equity Portfolio Diversification," concluded the number was disturbingly low. After examining more than 40,000 equity investment accounts at a large discount brokerage firm, 1991–1996, they found that the vast majority of investors held portfolios that were clearly undiversified, holding an average of just four stocks. Even investors with larger numbers of stocks tended to hold almost all the same kind (typically large-cap growth), thus benefiting very little from diversification.[1]

Several studies have revealed impediments on which investors stumble, failing to achieve adequate diversification:

- We mistakenly believe that holding numerous stocks ensures diversification even if the stocks are highly correlated (similar). While holding several stocks helps dampen the risk of individual holdings, it does not address the risk of concentrating too much wealth in particular asset classes.
- We are overconfident of our or our broker's stock-picking skills, assuming we are in the rare minority who can successfully identify "winning" stocks.
- We believe that we can better manage our portfolios by limiting how many stocks we hold. If we are familiar with a company, we argue, it must be a safer investment, leading us to concentrate our holdings in too few companies.

Evidence that so many investors succumb to such fallacies is particularly distressing, as a changing equity market has rendered diversification increasingly important. In December 1968, a paper published in the *Journal of Finance* concluded that an investor should doubt "the economic justification of increasing portfolio sizes beyond 10 or so securities."[2] By 2000, a newer study found that "even 60-stock portfolios achieve less than 90% of full diversification."[3] Yet another recent study argues that a dramatic increase in the volatility of individual stocks and a declining correlation of stocks within the S&P 500 Index has led to a significant increase in the number of securities needed to achieve the same level of portfolio risk.[4]

Despite the benefits of diversification, investors appear to have an increasingly difficult time constructing well-diversified portfolios. Explanations range from our own psyche to increasing challenges inherent in the market. Nevertheless, we are optimistic that investors can still achieve their objectives in today's market. Our helping hand can never hurt.

[1] Yale ICF Working Paper No. 00-59, October 2001.
[2] *Journal of Finance*, December 1968.
[3] *Journal of Investing*, Winter 2000.
[4] *Bloomberg Wealth Manager*, July/August 2000.

The Best and Brightest College Tuition Plans

In our Spring 2000 *Educated Investor* newsletter, we analyzed state college tuition plans that fall under the Federal tax regulations of Section 529 of the Internal Revenue code – "529 plans." At that time, we concluded that some may be of value under some circumstances. But we also recommended that readers carefully consider their other choices – such as the traditional "custodial account" or simply mental accounting of education funds within your own account.

Today, as improvements have been made, we believe 529 plans may prove to be a valid choice for many who are considering the best way to develop a college savings plan. Almost every state now has or is in the process of introducing its own 529 plan. This is good news for you, because you are not required to place your savings in your own state's plan. Thus, for example, as a New Jersey resident, you could use a Missouri state plan for your child to attend college in Oregon.

529 Characteristics

Each state forms an alliance with a specific investment provider to offer its plan. For example, Missouri and New York use TIAA/CREF, but Iowa and Utah are allied with The Vanguard Group. Thus some states' programs are better than others at enabling adherence to the passively managed investment approach we recommend. Each state decides what investment selections will be available, typically comprised of mutual funds with prescribed balances of equity versus fixed income. Asset allocations are generally based on the age of the child, with the allocations becoming more conservative over time. But several states now offer 100 percent equity options. We've seen annual fees ranging between 0.65-1.8 percent. It pays to shop around.

Contributors and Beneficiaries

The account is in your name for the benefit of the child. While most accounts are established by parents for the benefit of their children, any individual can establish a state plan for any beneficiary who is planning for qualified higher education. An account can later be rolled from the benefit of one child to the benefit of another member of that child's family.

Use of Proceeds

529 plan investments should *only* be used to pay for qualified higher educational expenses (but not limited to tuition) at any eligible college. Penalties and taxes are applied if funds are withdrawn and not used appropriately.

Investment Tax Implications

Contributions to a 529 plan are considered by the IRS to be a completed gift, removing the assets from your estate. Some states allow additional tax benefits if you invest in your own state's plan. You can roll over your 529 plan tax- and penalty-free among different state plans as often as once every 12 months to take advantage of more attractive options that may become available.

Withdrawal Tax Implications

When it comes to withdrawals, there is some good news. Effective in 2002, withdrawals are now free from federal tax. The catch is that this law is only in effect until 2010. If Congress declines to extend the law, withdrawals beyond 2010 will be taxed at the child's ordinary tax rate as it had been previously.

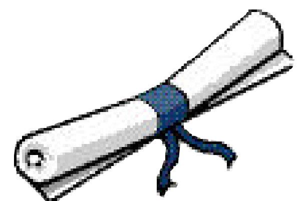
Weighing Your Options

To attract investments, states are competing against each other to offer the best plan. What may be the best choice today may not remain so into the future. Thus it is useful to include your 529 plans as part of your managed assets to ensure our up-front and ongoing assistance. Our advice to you will be unique based on your overall investment objectives, where you live (whether state tax benefits are or become available), your children's ages, investment options that are or become available, how large a role financial aid is likely to play, tax considerations and many other factors.

Are 529 Plans Right for You?

In our Spring 2000 article on college tuition plans, we compared 529 plans with custodial accounts as well as with savings within your own account. At that time, we concluded that some 529 plans had the potential to yield marginally better results, but that most of them faced serious hurdles, such as limited investment flexibility, conservative allocations and a negative impact on financial aid.

We are more optimistic today. As states compete against each other for investor dollars and as new options emerge, we are hopeful that the advantages available from many current 529 plans will more frequently outweigh the disadvantages. At the same time, with continual changes taking place at the state as well as at the federal level, ongoing consultation with us will be of more value than ever helping you select the best initial plan, and helping you change to new plans when it is in your best interest to do so.



Building Bond Portfolios (cont.)

- **Sector Concentration and Geographical Diversification** — We typically recommend holdings be diversified across multiple states and various economic sectors. (Consider, for example, what the outcome would have been for a 1999 investor who had purchased only California energy bonds.) Beyond diversification, we also remain current with specific sectors and states that offer higher quality relative to yield.

- **Tax Status** — Almost all munis are federally tax-exempt. A home-state muni is also typically state-tax-exempt, but we must carefully analyze it. Even without state tax exemption, an out-of-state bond may offer higher returns. Finally, some munis are subject to Alternative Minimum Tax (AMT), another factor that may affect our final recommendations.

Cost Control

Controlling costs can also add significantly to your end returns:

- **Understanding markup** — Among brokers' best-kept secrets is the markup between what they pay and the price paid by individual investors. Regrettably, such information is neither routinely nor freely available to the general public. When we analyze existing bond holdings using our Bloomberg database subscription, clients often are shocked to discover the markups they unwittingly paid, despite assurances that they were receiving "a good deal."

- **Negotiating improved rates** — Even if the markup is known, individual investors are often powerless to negotiate institutional-level pricing. As your investment advisor, we are the liaison between you and the bond broker. By participating in our collective purchasing power, you become part of a bond-purchasing "institution," enjoying significantly reduced broker markups. And because we manage your portfolio based solely on assets under management, we never add markup fees of our own.

- **No conflict of interest** — Another benefit of our standing between you and the broker is that we have the freedom and purchasing power to work with multiple brokers who compete against each other for your business, both in buying and selling your bond holdings. With no in-house bond inventory, we have no vested interest — other than your best interests — in the securities we make available to you.

Are Muni Bonds Right for You?

While a muni bond portfolio has the potential to help your investments go that extra mile, they are not for everyone. As mentioned previously, munis are usually tax-exempt. They also require a relatively higher level of investment to achieve the desired diversity, ensure cost-effective transactions and establish an appropriate bullet or ladder construction. Thus investors whose fixed-income holdings are modest or are held in tax-sheltered accounts may better achieve their goals through other means. Regardless, we are available to help you determine which fixed income option makes the most sense for you.

Instant Answer
(from page 1)

1. Unfortunately, while regulators require brokers to trade at prices that are "fair and reasonable," there are (c) no limits when it comes to markups. We have seen different brokers' prices for the same bond vary as much as 10 percent in a given day. We can help minimize the markup you pay.

2. (b) False. Bond brokers typically make more profit from bonds that they inventory in-house and therefore have a vested interest in selling them to you whether or not they are the best selection for your needs.

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

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