

INCOME BUILDER

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Major Points

- High Quality, Short-Term Corporate Bonds Can Deliver Attractive, Inflation-Adjusted Returns with Much Less Downside Risk.
- Accordingly, They Should Form the Core of Many Investment Portfolios.
- This Bulletin Describes Three Strategies for Investing in Bonds
 - Mutual Funds
 - Individual Portfolios
 - Investment Clubs
- Current Trading Practices Suggest That It Is Advantageous for Investors to Work Directly with a Broker's Representatives to Purchase Bonds

FIXED INCOME INVESTING

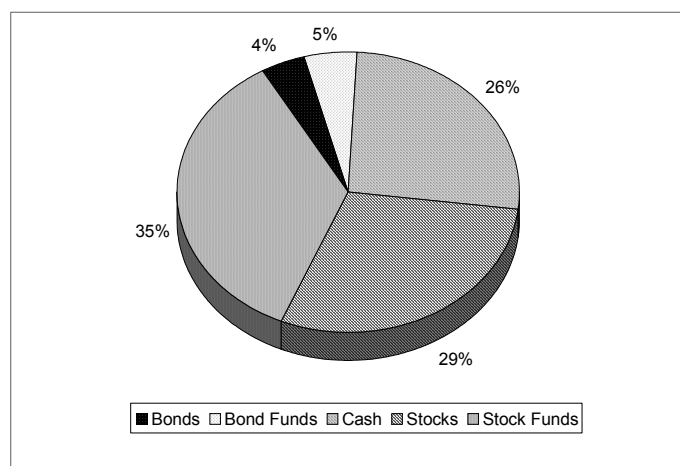
BY STEPHEN P. PERCOCO

Most individuals carry an underweighted position in bonds in their investment portfolios. According to a recent poll, the average member of the American Association of Individual Investors has only 9% of his or her portfolio invested in individual bonds or bond funds. This compares with a 64% weighting in individual stocks or stock funds and 26% in cash.

It is true that the self-selected AAI members included in this poll may be an unusual bunch. Compared to the average investor, for example, they are much more likely to buy individual stocks. Nevertheless, a low fixed income weighting is almost certainly a feature of the typical portfolio of the broader universe of investors.

Most individuals view stocks as their primary investment vehicle. If they are worried about the stock market, they are more likely to shift some of their assets to cash instruments, such as money market funds or bank CDs. Well-heeled investors may also include municipal bonds or

Chart 1
Average Asset Allocation of AAI Members, January 17, 2008



Average asset allocation of members of the American Association of Individual Investors from a poll on the AAI Web Site (based upon members responding).

municipal bond funds in the mix. But few investors consider the full range of fixed income securities as investment options.

It is unfortunate that investors do not pay more attention to the rest of the fixed income sector. By devoting a higher proportion of their assets to

fixed income, I believe that investors can earn solid, inflation-adjusted returns with much less downside risk. In addition, developing financial market trends often show up in the fixed income sector early on; so focusing on fixed income will make you a better stock investor.

INFORMATION RESOURCES FOR FIXED INCOME INVESTORS

Most fixed income investment resources are geared to institutional investors and are therefore either difficult to obtain or quite expensive. Still, there are many fixed income information sources available for individual investors which are quite useful.

First, I recommend that you look closely at your existing resources, especially major newspapers such as the Wall St. Journal, New York Times and Financial Times. You probably have focused primarily on stock-related investment information and so will

likely find, to your great surprise, that each of these newspapers offers something unique and useful for fixed income investors.

Beyond that, as you might imagine, there are many information sources available for

(Continued on page 10)

WHY PAY ATTENTION TO THE BOND MARKET?

“Expanding your attention to the bond market and the various segments within it will give you a better perspective on forces that will affect the performance of your investment portfolio. As a result, it will help to make you a better investor”

Interest rates are a key determinant of economic activity. They influence the rate of spending by consumers and businesses, especially for big ticket items.

Interest rates have a direct impact on consumer purchase decisions. Mortgage rates establish just how much consumers can afford to pay to purchase a home. Thus, they affect house prices and overall housing construction activity. Interest rates also help set automobile manufacturing production levels and should serve to regulate consumer spending behavior through credit cards.

Similarly, interest rates on commercial loans and leases affect spending by businesses on new facilities and equipment. They also influence whether companies will take on ambitious new projects that may not generate positive cash flow for several years.

The Federal Reserve plays a key role in determining interest rates on consumer and commercial loans. Through its management of the Federal Funds rate and bank reserve require-

ments, it has a direct influence on bank lending policies. Its efforts also help to shape the U.S. Treasury yield curve, which is the benchmark off of which all other types of loans are priced.

Interest rates have a direct impact on stock prices. In theory, the value of a stock is a function of projected earnings (or dividends) discounted back at a rate that reflects their risk. The choice of a discount rate is influenced directly by the general level of interest rates. Interest rates also affect corporate profits. As a result, understanding interest rate trends can help you assess the relative attractiveness of the overall stock market, as well as individual stocks,

Fixed income investing will make you much more aware of the impact of interest rates on the economy. It will also help you to anticipate and respond to interest rate trends. Expanding your attention to the bond market and the various segments within it will therefore give you a better perspective on forces that will affect the performance of your investment portfolio. As a result, it will help to make you a better investor.

FIXED INCOME SECTORS: COLLECTIVELY MUCH BIGGER THAN THE STOCK MARKET

Based upon a rough estimate of the total value of the DJ Wilshire 5000, which is said to capture 90% of the value of the stock market, I estimate that the overall U.S. stock market is roughly \$17 trillion in size. By comparison, the

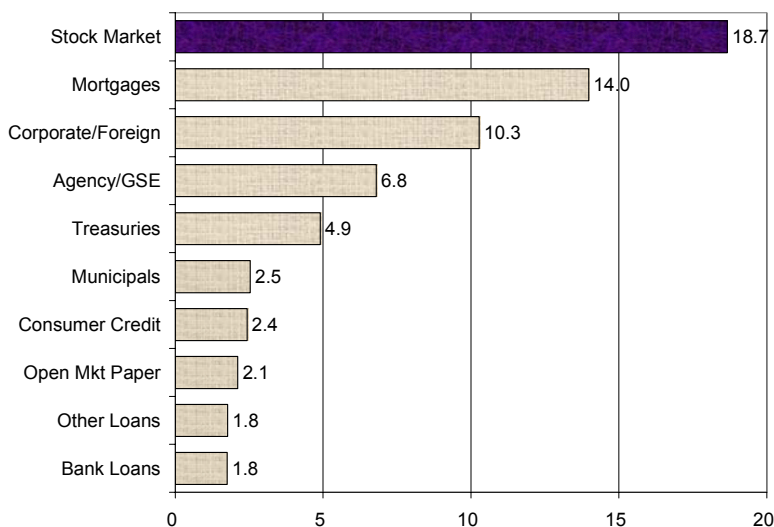
U.S. mortgage market is \$14 trillion; corporate and foreign bonds (denominated in U.S. dollars) are \$10 trillion, U.S. Treasuries are about \$5 trillion and municipal bonds are about \$2.5 trillion. (All of this is based upon Federal Reserve figures.)

There is some overlap in the various bond sectors as presented here. For example, most mortgages are financed by Agency and GSE securities. So the total investable universe is smaller than the \$46 trillion sum of all of the fixed income sectors, as presented in Chart 2. Even so, the bond market is collectively much bigger than the stock market.

Some of these sectors are dominated by institutional investors; but most are accessible to the individual investor, if not directly, then through bond mutual funds. Over the past decade or so, sectors that have been mostly closed to individual investors have opened up. Today, individual investors have greater access than ever to corporate, Federal Agency and municipal bond offerings, for example, either through financial advisors at traditional brokerage firms or from relatively new trading platforms at discount brokers.

Chart 2

Fixed income sectors vs. the stock market (in \$ trillions)



Source: U.S. Federal Reserve, Income Builder estimates

WHAT IS A BOND?

A bond is a legal obligation of an enterprise. It gives the holder a **claim** that is sometimes secured by a lien on the enterprise's assets (in the same way that a mortgage is secured by a lien on a house). If the claim is unsecured, the bondholder has the right to a share of the enterprise's unsecured assets, along with other unsecured creditors. Most publicly-traded corporate bonds are unsecured.

In contrast, common shareholders have an **interest** in the net assets of a corporation. Since shareholders do not have a contractual claim, the corporation has a fiduciary duty to conduct its affairs in the best interests of its shareholders. Should the corporation fail in that duty, shareholders typically suffer substantial losses. In a bankruptcy filing, shareholders usually recover little of their original investment and often suffer a total loss.

Besides the requirement to pay interest and principal on a timely basis, many bonds place restrictions on a company's actions. These are known as **covenants**.

Covenants take many forms. For example, they

can limit a company's ability to incur debt, merge with others or pay dividends to shareholders. They may also require the company to maintain a minimum level of net worth.

If a company fails to correct a covenant breach within a specified time period, then bondholders usually have the right to accelerate the repayment of principal (and any interest due). In theory, the right to accelerate allows bondholders to maximize their recovery by preventing any further erosion in the company's value,

In practice, the restrictiveness of covenants is usually a function of the relative bargaining powers of a company and bondholders at the time that bonds are issued. Financially weaker companies are usually saddled with more restrictions.

It is useful for investors to become familiar with all of a bond's terms, including the covenants. However, in my experience, the only protection that has proven its value time and again is a security interest (i.e. a lien against some or all of the assets of a company). Alternatively, a pledge by a company not to grant liens to other creditors - i.e. a "negative pledge" - is also valuable.

BOND MATH BASICS

The primary formula that you must learn to understand bond math is basic compound interest:

$$fv = pv * (1 + i)^n$$

and its corollary:

$$pv = \frac{fv}{(1 + i)^n}$$

where pv = present value, fv = future value, *i* = interest rate and n = number of periods.

From the corollary formula, you can see that the more the interest rate (*i*) increases, the bigger the denominator and therefore the lower the present value. Thus, as interest rates rise, the price of a bond falls.

Likewise, the longer the maturity of the bond - here represented by n or the number of periods - the bigger the denominator and therefore the lower the value. Thus, bonds with longer maturities suffer greater price declines than shorter maturity bonds, when interest rates rise.

The table below, reproduced from a recent issue of the AAIL Journal, shows the price sensitivity of bonds with various maturities to an increase in bond yields of 2% (or 200 basis points). For example, a 2% increase in interest rates will cause a price decline of 8.5% in a bond with a 4% coupon and 5 year maturity. That same 2%

rate rise will cause a similar coupon bond with a 30-year maturity to fall 27.7% in price. The message is clear: if you want to minimize interest rate risk, invest in bonds with short- to intermediate maturities. On the other hand, if you believe that interest rates will fall, then buy long term bonds.

With recent declines in interest rates, long-term government bonds have been the best performers. However, rates have fallen to extremely low levels, so it is unlikely that they will fall much more. At the same time, the risk of an increase in rates has now, I believe, risen appreciably.

Table 1
Bond Price Sensitivity Assuming 2% Rate Rise

Years to Maturity	4% Coupon Bond	6% Coupon Bond
1	-1.9%	-1.8%
5	-8.5%	-8.1%
10	-14.9%	-13.5%
20	-23.1%	-19.7%
30	-27.7%	-22.6%

Source: AAIL Journal, December 2007

Key Terms:

Par Value: Also known as face value, this is the contractual amount of principal due at maturity. It is almost always equal to \$1,000 per bond.

Bond prices are usually quoted as a percent of par value (i.e. par value is 100). So a bond price of 98 equals 98% of par or \$980 per bond.

Basis Point: 1/100% or 0.01%. 2% equals 200 basis points.

Yield-to-maturity The annualized total return on a bond held to maturity. It is equal to the discount rate which equates the contractual cash flows on the bond to its price. By convention, it is equal to the semi-annual yield multiplied by two. (This is because most bonds pay interest on a semi-annual basis.)

Yield-to-call: The total return on a bond calculated to the date that a company can exercise its option to call the bond (i.e. retire it before it matures). Companies will seek to call a bond if they can refinance at a lower contractual interest rate. Usually, however, by the terms of a bond, the company must pay a premium to the bondholder to exercise its call option.

Yield-to-worst. This is equal to the lower of either the yield-to-maturity or yield-to-call. If the yield-to-worst equals the yield-to-call, the bond market implicitly assumes that the bond will be called.

THE YIELD CURVE

“Many market strategists view the short end of the yield curve as an indicator of Federal Reserve Policy. Thus, with the 2-year Treasury note currently yielding less than 2%, the market is betting that the Fed will lower the target on the Fed Funds rate by another 100 basis points.”

“It is unlikely, in my view, that interest rates will go much lower from here. If I am correct, then the downside risk on long-term Treasury bonds clearly outweighs their upside potential.”

Although the U.S. Treasury yield curve represents a snapshot of current interest rates at various maturities, it also reflects expectations about future short-term interest rates.

To see this, we must “disaggregate” a long-term Treasury bond into its components. Viewed in this way, the 10-year Treasury note is a composite of one-year Treasury note yields taken successively over the 10-year period.

Given current pricing, the market is implicitly anticipating that short-term (i.e. one year or less) Treasury rates will remain below 2% for the next two years, then jump to 2.75% in 2010 and to around 3.50% in 2011.

Many market strategists see the short end of the yield curve as an indicator of Federal Reserve policy. With the 2-year Treasury note currently yielding less than 2%, the bond market is betting that the Fed will lower the Fed Funds rate by another 100 basis points before too long.

Of course, sentiment can change quickly. Chart 3 shows that at mid-year 2007, just 8 months ago, the yield curve was essentially flat at around 5%. By the end of 2007, the short-end of the yield curve downshifted, following the Fed’s decision to cut the target Fed Funds rate sharply. Throughout this period, the Treasury market anticipated the Fed’s moves well in advance of its actions.

Investors who held long-term Treasury bonds (or bond funds that hold primarily long-term Treasury bonds) earned superior returns during the last half of 2007 and also for the first two months of 2008. Those investors, however, were willing to take on certain risks to achieve those returns. For one, they apparently believed that the Fed would abandon its vigilant stance

against inflation, despite initial Fed statements to the contrary. They also were willing to bet that foreign investors would not penalize the U.S. too severely for its interest rate actions, by pushing down the value of the U.S. dollar, which would have surely pushed inflation higher, forcing the Fed to raise rates.

In fact, the Fed appears to have abandoned its conservative stance towards inflation in the face of mounting criticism about a slowdown in the economy from Washington and Wall Street. As might be expected, the dollar fell sharply throughout most of 2007. It has stabilized somewhat since November, but this respite may prove to be temporary.

Going forward, how much, if at all, are interest rates likely to fall? The Fed recently predicted that core inflation will range from 2.1% to 2.4% this year, above its target range of 1% to 2%. Headline inflation is currently running at around 4% or so and could go higher. With inflation running at persistently high levels, it is unlikely in my view, that interest rates, as measured by the Treasury yield curve, will go much lower from here. If I am correct, then the downside risks on long-term Treasury bonds clearly outweigh their upside potential.

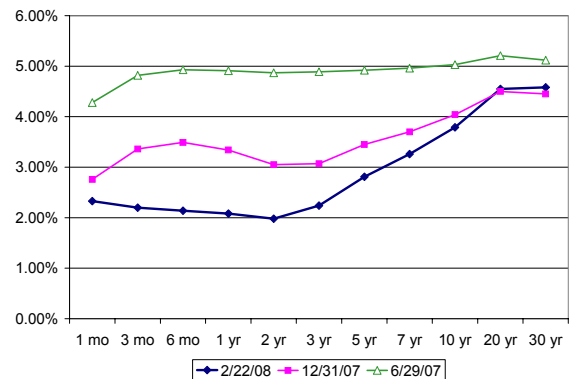
Of course, time will tell whether the current yield curve proves to be a good predictor of future interest rates. Clearly, the bet is that the Fed will lower the target Fed Funds rate again, but recent inflation reports, in-

Table 2
U.S. Treasury Yield Curve
as of Feb. 22, 2008

1 month	2.33%
3 months	2.20%
6 months	2.14%
1 year	2.08%
2 years	1.98%
3 years	2.24%
5 years	2.81%
7 years	3.26%
10 years	3.79%
20 years	4.55%
30 years	4.58%

cluding a distressing 1% jump in January producer prices, have caused some market watchers to predict that the Fed will not cut the benchmark rate as aggressively going forward. Once it is clear that the economy is on the mend, some predict that the Fed will retreat from its accommodative stance just as quickly as it cut rates.

Chart 3
Recent Shifts in the Yield Curve: Mid-2007 to Early 2008



Source: U.S. Treasury Dept.

REAL INTEREST RATES AND YIELDS ON TIPS

With yields running around 2%, investors seeking the safety and a lower level of interest rate risk that are inherent in short-term U.S. Treasury securities now have to accept a return that is below even the core rate of inflation.

Ten-year Treasuries do not seem to be much more of a bargain. At their current yield of 3.79%, the 10-year provides a return that is 1.29% above the 12-month core rate of consumer inflation, which was 2.5% in January 2008, but more than 50 basis points below the headline rate of consumer inflation of 4.3%.

Some economists, perhaps many, believe that the rate of inflation will slow along with the rest of the economy in 2008. Even if it does, potential investors in the 10-year ought to ask whether they believe that the rate of inflation will be below 4% on average over the next 10 years. If their answer is yes, then the 10-year may be a good investment. If not, they should look elsewhere.

The “breakeven inflation rate” between Treasury and TIPS provides another gauge for the relative attractiveness of Treasury securities. It is calculated by subtracting the yield on a given TIPS from the yield on the comparable ma-

turity Treasury security. Recall that the yield on a TIPS is equivalent to a real interest rate; that is, the return earned over and above inflation. (The inflation-adjustment component on TIPS is based on the annual rise in the headline CPI and is added to the principal amount of the bond.) So the breakeven rate, the difference between the straight Treasury yield and the TIPS yield, is equal to the implicit inflation assumption built in to the yield on the straight Treasury security.

For example, the yield on the 10-year Treasury note is 3.76% and the yield on the 10-year TIPS is 1.43%. So the breakeven yield is equal to 2.33%. Thus, if you believe that the average rate of inflation is likely to be below 2.33%, buy the 10-year Treasury. If you think it will be higher, then you would earn a higher return with the 10-year TIPS.

Similarly, the yield on the 5-year Treasury note is currently 2.76%, while the yield on the 5-year TIPS is 0.63%. So the breakeven inflation on the 5-year is 2.13%.

This analysis suggests that TIPS may be a relatively attractive investment, but I do not think so. The charts below show the average weekly yields on 5-year and 10-year

TIPS. You will note that yields on both of these instruments peaked in the summer of 2007. (By good fortune, I added 5-year TIPS to the portfolio in June 2007, just as TIPS yields were peaking.) Since then, they have dropped sharply, along with the drop in Treasury yields.

At current levels, yields on the 10-year TIPS are at a five year low; while the 5-year TIPS are near their recent historical lows.

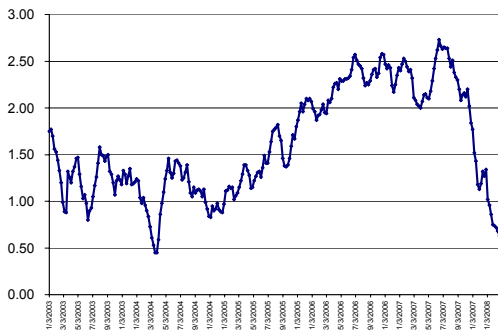
Thus, prices of TIPS securities have rallied sharply over the past several months. My 5-year TIPS, for example, have increased from about 98 to 106, which along with their 2.75% yield, has produced a total return of more than 11% in the past eight months. No wonder, then, that TIPS funds were among the best performers in the fixed income sector in 2007.

As was the case in the first half of 2007, TIPS will decline in price, when investors demand higher current (i.e. real rates). With yields currently at 5-year lows, the odds that TIPS will decline in price are much higher now. TIPS may still be a reasonably good investment for the buy-and-hold investor, but you will probably be able to buy them at better prices within the next year or so.

“With yields running around 2%, investors seeking the safety and a lower level of interest rate risk that are inherent in short-term U.S. Treasury securities now have to accept a return that is below even the core rate of inflation”

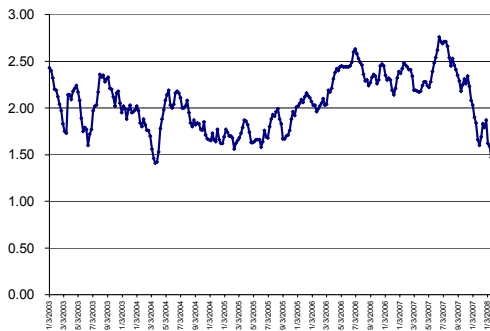
“TIPS may still be a reasonably good investment for the buy-and-hold investor, but you will probably be able to buy them at better prices within the next year or so.”

Chart 4
Average Weekly Yields on 5-Year TIPS



Source: U.S. Federal Reserve

Chart 5
Average Weekly Yields on 10-Year TIPS



Source: U.S. Federal Reserve

Key Terms:

Yield Spread: a bond's excess yield, measured in basis points, over the comparable maturity Treasury security. This excess yield represents compensation to the investor for assuming certain risks, including the possibility of default, sub par trading liquidity and higher than anticipated inflation.

“The recent sharp increase in spreads reflects growing concerns about the probability of rising defaults in the junk bond sector, but at these levels, there ought to be some great bargains too.”

YIELD SPREADS: A MEASURE OF COMPARATIVE VALUE

To compare the relative value of one bond against another, investors typically consider bond spreads.

For example, if Florida Power & Light 5.55% Senior Notes due 11/1/2017 are trading at 5.09% and the comparable 10-year Treasury is yielding 3.79%, then the spread on the FP&L 5.55s is 130 basis points.

Since FP&L is a AA-rated credit, you might first want to compare its spread to other AA-rated companies. Fortunately, several of the major brokerage firms, including Lehman and Merrill Lynch, for example, maintain various corporate bond indexes that facilitate such comparisons. In our case, other AA-rated bonds recently carried spreads of about 175 basis points. So FP&L's 130 basis point spread makes it a little

rich. The question that you as an investor considering the purchase of the FP&L bonds must ask is whether the low spread is worth it? Just as with beauty, value is often in the eye of the beholder.

Performance so far this year in the U.S. corporate bond market has been mixed. Investment grade corporate bonds have performed well, somewhat mirroring the strong performance in U.S. Treasuries.

As indicated in Chart 6 below, the FINRA/Bloomberg Investment Grade Index has earned a total return of 1.2% so far this year and 5.64% over the past 12 months. By comparison, the Ryan Index, an equal weighted portfolio of 2 yr.-30-yr. maturity Treasury bonds, has delivered a 1.8% total return year-to-date.

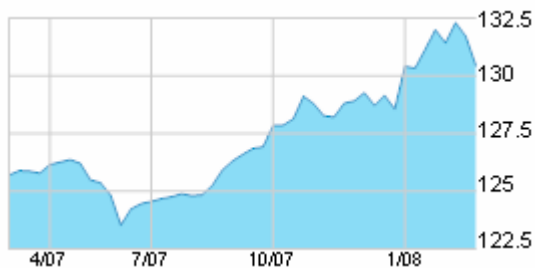
At its current average yield of 5.66%, the investment grade index carries a spread of 285 basis points, an increase of 50 basis points since the beginning of the year.

This past week, the business media sounded the warning alarm as investment grade spreads began to approach

300 basis points, a level not seen, so they say, since the Great Depression. The WSJ noted that the cost of credit insurance (as measured in credit default swaps) had doubled recently to about 150 basis points, a sign of market concern about rising credit risk. Clearly, if the economy heads toward a recession, concerns will rise across all financial instruments, but the investment grade sector should prove to be among the safest in the bond market.

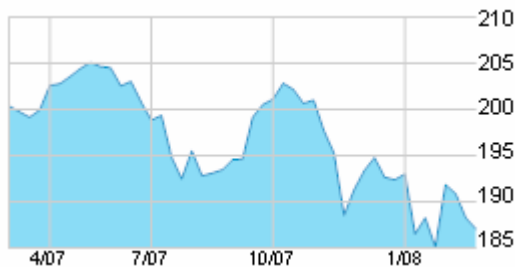
On the other hand, rising spreads in the high yield market are a source of concern. So far this year, the FINRA/Bloomberg High Yield Index has declined 2.7%, as spreads have widened from about 725 to 875 basis points. Last year at this time, the spread on this index was about 310 basis points. The recent sharp increase in spreads reflects growing concerns about the probability of rising defaults in the junk bond sector; but at these levels, there ought to be some great bargains too.

Chart 6
Total Return on the FINRA/Bloomberg Investment Grade U.S. Corporate Bond Index



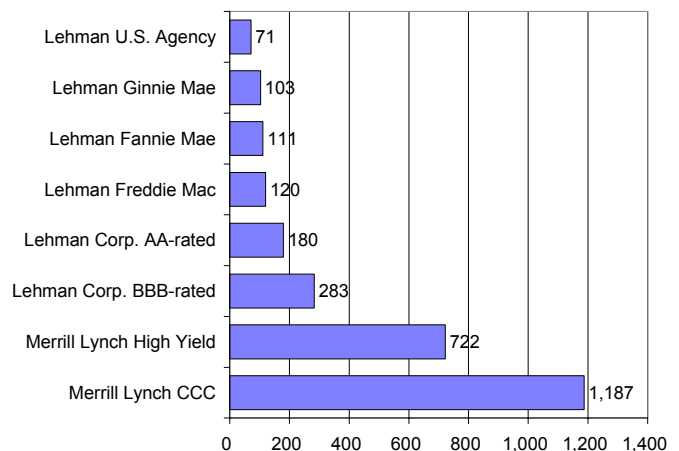
Source: FINRA.org;; index value = 131.25 as of 2/22/08

Chart 7
Total Return on the FINRA/Bloomberg High Yield U.S. Corporate Bond Index



Source: FINRA.org; index value = 187.51 as of 2/22/08

Chart 8
Spreads on Various Corporate Bond Indexes (January 31, 2008)



Source: Wall St. Journal Online (online.wsj.com)

CREDIT ANALYSIS: THE KEY TO PROTECTING PRINCIPAL

If you invest in lower yielding, investment grade bonds, defaults can decimate your portfolio returns; but the odds that higher-rated bonds will default are admittedly low.

Table 3 gives estimates of one-year default probabilities for each rating category, according to Fitch Ratings. The table shows that investment grade bonds (i.e. those rated BBB or above) typically have less than a 1% chance of defaulting in a single year.

By comparison, high yield or junk bonds, those rated BB and below, have much higher one-year default probabilities.

Credit ratings are an excellent indicator of credit quality.

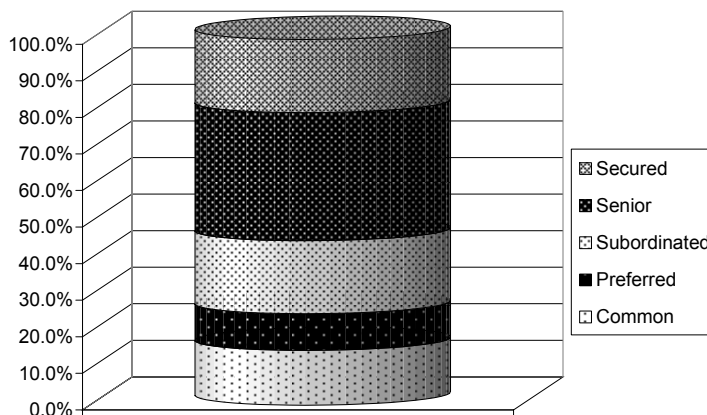
Although the reputations of the credit ratings agencies have been tarnished by the collapse of the sub-prime mortgage sector (in which values of many AAA-rated securitized bonds collapsed because of the impact of rising mortgage defaults), the value of credit ratings have been proven over many decades.

Table 3
Estimated One-Year Default Probabilities for Bonds by Credit Rating

AAA	0.06%
AA	0.12%
A	0.27%
BBB	1.02%
BB	5.42%
B	10.43%
CCC	29.68%
CC	37.74%

Source: Lark Research calculations from WSJ online data originally sourced from Fitch Ratings

Chart 9
The Relative Priority of Claims vs. Interests



I prefer to use credit ratings as an initial indicator of the creditworthiness of a bond. After that, I will almost always perform my own credit analysis to confirm for myself the credit rating.

Besides the key credit measures given in the column on the right, I use many of the same measures that stock analysts use, such as profit margin trends, projected cash flows and market share dynamics, to name a few.

Since bondholders have a more senior claim against the assets of a company, they typically enjoy a greater margin of safety. Stock analysts must be concerned with the actual levels of corporate profits and cash flows, because variations in these can have a big impact on stock prices.

To be sure, changes in earnings and cash flows do affect the value of a bond. A drop in corporate earnings will usually cause the yield spread to widen, as the market raises its estimate of default risk. However, dollar for dollar, the impact of earnings changes on bond values and yield spreads is typically more muted than stock prices.

Often, the choice of where to invest in the capital structure can have a big impact on overall returns. Chart 9 shows the relative priority of claims by creditor class.

Secured claims rank highest. As we have seen with Calpine Generating Company, secured bonds give investors powerful rights which often ensure the full recovery of principal and interest, even in a bankruptcy.

Financial risk increases as we move down the capital structure. In a bankruptcy, senior unsecured bonds will usually recover less than secured bonds, but more than subordinated bonds. Common equity is at the bottom of the pile. These days, shareholders often get wiped out completely in a bankruptcy.

Knowing the relative priority of a bond's potential claim against a company is an important part of credit analysis.

Bondholders at the lower levels of the capital structure usually receive a higher yield to compensate them for the added risk, but unless you are confident that the company's prospects are good, this slightly higher yield is often inadequate.

3 Key Credit Measures:

Debt Service Coverage: This is a measure of the ability of a company to meet its debt service obligations. It is usually expressed as the ratio of earnings or cash flow divided by interest expense. Many analysts use EBITDA (or earnings before interest, taxes, depreciation and amortization) divided by interest expense. Typically, the higher the number the better. So a company with an EBITDA-to-interest expense ratio of 6-to-1 is usually in a stronger financial position than a company with a 1.2-to-1 EBITDA-to-interest expense ratio. But it is important to compare individual company debt service measures against industry averages. If the company's cash flows are stable, it should be able to operate with higher debt levels. Thus, a company with a 2-to-1 coverage ratio may sometimes be a better credit risk than a company with 5-to-1 coverage.

Debt-to-total capitalization. A measure of financial leverage. Total capitalization equals the sum of debt and equity on the balance sheet. So the debt-to-total capitalization ratio tells you what proportion of the company's total capitalization consists of debt. Here again, it is important to compare your company against industry averages, since some industries, like finance companies, usually operate with higher debt levels. It is also important to take into account, by reading carefully the financial statement footnotes, debt that may be carried off the balance sheet.

Liquidity. Usually measured as cash and equivalents plus amounts available to be borrowed under bank credit lines. Compare this to the net free cash flow that a company generates each year, annual capital expenditure requirements and upcoming debt repayment obligations

PUTTING IT ALL TOGETHER

In the current uncertain and volatile market environment, I believe that a portfolio with high quality, short-term fixed income securities at its core can deliver attractive, inflation-adjusted returns over the long haul. This core would consist primarily of highly-rated (i.e. investment grade) U.S. corporate bonds, Treasury notes, bank certificates of deposit and similar securities.

This portfolio would seek to employ primarily a buy-and-hold strategy; virtually all of the securities would be purchased and held until maturity. To minimize interest rate risk, the average maturity of the bonds in the portfolio ought to be limited to no more than five years and preferably around three years.

The target return on the portfolio would be 100-200 basis points over the rate of inflation. With inflation running around 4.3% currently, the goal under current market conditions would be to achieve a total return of 5.3%-6.3%. Today, this translates into an average yield spread of 250-350 basis points over Treasuries.

These total return parameters would require us to focus mostly on U.S. corporate bonds rated single-A to BBB. This, I believe, is a good sandlot in which to play. This lower range of the investment grade sector offers decent yield spreads at what should be acceptable levels of risk. From time-to-time, we should also be able to find other securities, such as TIPS or bank CDs, for example, which meet our target return parameters for our core portfolio.

In order to achieve an average return of say 5.8%, the middle of our range, which today represents a yield spread of 300 basis points, we will also need to look at certain sectors outside of the core that have the potential to deliver higher tax- and inflation-adjusted returns. These might include high yield corporate bonds, REITs, closed end bond funds, municipal bonds, preferred stocks and even certain high yielding equities, such as master limited partnerships. Obviously, many of these investments carry higher risk levels, as well. However, we should limit them to no more than say, 30% of the portfolio.

It is important to note that over time the composition of the entire portfolio, including the core, may shift somewhat along with market conditions. For example, if yield spreads rise sharply - well above the rate of inflation - due to growing concerns about a more severe slowdown in the economy, we might seek to shift the portfolio's exposure toward higher rated bonds, say those rated AA and above, because they can help us to meet our target return objectives with less risk. At the same time, we might conclude that the selling in certain securities, say in the junk bond sector, for example, has been overdone at least with respect to a few companies whose businesses and

financial positions ought to remain solid, even in a tougher economic environment. In these cases, we might reach a little bit into riskier, lower quality sectors of the bond market to augment our returns.

In this way, we should be responsive to current market opportunities and risks, recognizing, however, that any portfolio changes that we make will most likely be gradual, because we have committed most of our funds to investments that we intend to hold to maturity. Only in extreme circumstances - in response to say a significant deterioration in the prospects for a company whose bonds we hold - should we consider selling any security before it matures.

I believe that this strategy offers a better risk/reward profile over the next 5-10 years than a traditional investment portfolio that relies on a heavy weighting in common stocks. The U.S. stock market has enjoyed an incredibly long run with above average

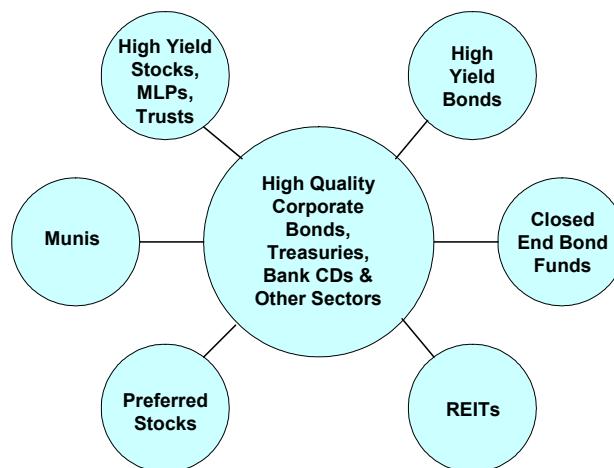
returns for more than a quarter century now. Many of the problems that we have seen recently, such as the sub-prime mortgage mess and the sharp decline in the value of the dollar, may very well be only the first wave. It could take this country at least several years to work these problems out and the stock market would likely suffer during the workout process.

I am not saying that all stocks will be poor investments for the foreseeable future. As the saying goes, it is a market of stocks, not just a stock market. Many companies may be able to weather the storm successfully. Furthermore, with some adjustments, including possibly a

modest amount of inflation, it is possible that the stock market could still deliver decent returns.

But it would be surprising if the ride is not bumpy somewhere along the way. If I am correct in my assessment, then investors who pursue an investment strategy focused primarily on high quality, short maturity bonds should experience less overall stress. In baseball terms, the goal here is to focus on hitting singles and an occasional double, not swing for the fences. Consequently, we should end up striking out less often.

That does not mean necessarily that we will be able to avoid losses. I believe that this strategy, while clearly more boring than the pursuit of hot stocks, is not without its pitfalls. In this sector, the highest annualized rate of return that you can possibly expect on a single investment is maybe 15%. In stocks, having some big winners helps to offset some of your losers. With a bond-focused strategy, any losers can quickly erode your returns. Under the approach that I have described here, you should be able to sleep better at night, but you will almost certainly have to work just as hard, if not harder, during the day.



THREE APPROACHES TO A BOND-FOCUSED INVESTMENT STRATEGY

Option 1: The Mutual Fund Approach

Some financial advisors, such as Suze Orman, are not fans of bond mutual funds. They believe that fund expenses generally are too high. They also believe that you lose some of the inherent advantages of owning your own bond portfolio, like the buy-and-hold-to-maturity strategy, because bond funds constantly roll over their investments and so do not have a set maturity. This gives investors at least some exposure to market risk upon redemption. More recently, Business Week reported that many bond funds are trafficking in credit default swaps. As a result, investors in these bond funds may be getting something for which they did not bargain: they may be exposed to potential losses in the future on these arcane financial instruments.

All other things being equal, I too believe that a self-managed bond portfolio is preferable to a portfolio of bond mutual funds. However, many investors do not have the knowledge and are unwilling to devote the time to learn how to create and manage their own bond portfolios. For those investors, I believe that bond mutual funds are an excellent alternative. Although annual fund expenses generally run from 0.50% to 1.00%, that should be money well spent. As noted, it takes a lot of work to manage these portfolios; so it is in the best interest of investors that fund managers are adequately compensated.

Under this approach, investors primarily play the role of a strategist. High quality short-term bond investments should still be at the core of this portfolio, but investors can take advantage of opportunities and try to reduce risks by monitoring financial market trends. For example, they should monitor yield spreads across various sectors within the bond market to identify areas of opportunity and risk. They should then reweight portfolio allocations by shifting money from one or more bond funds to others in response to developments in the economy and financial markets.

Option 2: The Individual Investor Approach

This, I believe, is a better approach, but it requires a more significant commitment of time and effort by the individual, especially at the outset, to learn about bond investing, including how to monitor the bond market, spot good relative values, assess the likelihood of default and purchase securities at the best prices. Once the individual is up to speed, it should require no more work than a stock portfolio. Experienced investors with good experience in researching and investing in common stocks should find the task much less daunting. In fact, a company whose stock is viewed as high quality (or low risk) should also be an issuer of high quality bonds. In this way, experienced stock investors may be able to use their existing knowledge to develop an initial target list of bond investment candidates.

In order to pursue this strategy effectively, some investment advisors believe that you must be able to commit at least \$50,000 to this strategy. From my perspective, this may work if you are focusing mostly on T-bills, TIPS or bank CDs. However, if you are seeking to buy individual corporate or municipal bonds, I believe that investors ought to be willing to devote at least \$100,000 to a portfolio, consisting of 10 separate investments of \$10,000 each. This is necessary to achieve an acceptable level of diversification. Most brokers view \$10,000 - equal to a purchase of 10 bonds, each with \$1,000 par value - to be the smallest desirable order size. Some advisors, such as the Richelsons, believe that each of your bond positions should be \$25,000 in size in order to get the best price offerings. If you are unable to commit \$100,000 to this strategy, then you are better off pursuing either Option 1: The Mutual Fund Approach or Option 3: The Investment Club Approach, discussed below.

Option 3: The Investment Club Approach

From my perspective, this is the most desirable approach, but it also requires a lot of work, especially in the beginning. Here, a group of investors gets together and pools their money to purchase a portfolio of bonds. This is not an uncommon approach in stock investing. Indeed, the National Association of Investment Clubs (www.better-investing.org) serves thousands of clubs across the country. An investment club requires the establishment of a legal entity, usually a partnership, that is governed by a formal agreement and a set of by-laws or operating procedures. In my opinion, a bond investment club should have minimum capital of \$200,000, which would allow it to buy eight \$25,000 positions or twenty \$10,000 positions. Better still to have \$500,000 to put to work, as this would give the club the ability to pursue larger bond positions and/or a wider range of fixed income investment opportunities.

According to those experienced in the operation of investment clubs, members should ideally have the same investment philosophy to ensure that the club runs smoothly and avoids conflicts. With stock investing, it is much more likely for there to be a wide range of investing styles and strategies, ranging from short-term day-trading to long-term buy-and-hold investing or from growth-oriented to dividend-oriented investing. With the bond investment strategy that I have articulated here, however, I believe that it would be much easier for club members to "be on the same page."

One primary advantage of the investment club approach is that it makes it possible to spread the workload more evenly, so that all club members can benefit from the group's collective efforts. Some investment club veterans say that this is nice in theory, but difficult to achieve in practice because most of the work ends up falling on only a few shoulders. That would be a shame, especially in this situation. Since bond investing is a relatively new arena for the individual investor - one that is likely to grow rapidly in the coming years - an investment club offers everyone the opportunity to learn about all aspects of it much faster than if each operates on his or her own.

INFORMATION RESOURCES FOR BOND INVESTORS

(Continued from page 1)

fixed income investors on the web. Here is my list of some of the most useful resources:

FINRA.org (Financial Industry Regulatory Authority). FINRA is the independent regulatory authority formed by the merger of the regulatory arms of the NYSE and NASD. It developed a system known as TRACE (Trade Reporting and Compliance Engine) through which brokerage firms who are FINRA members are required to report their fixed income trades. The data produced by the TRACE system is available to individual investors through this website.

Market Data: FINRA's market data section, www.finra.org/marketdata, provides useful information on both the stock and bond markets and includes several sections. The main page has a 17-min. tutorial that points out all of the features available on the site.

Company Information: Provides a snapshot of information including recent trading prices for a company's equity and fixed income securities, all on one page.

Bond Center: <http://cxa.marketwatch.com/finra/BondCenter/Default.aspx>

This is the gateway that provides access to the TRACE fixed income trading database. It offers a simple screener (with a link to an Advanced Bond Screener) that allows individual investors to search for information and trading data on U.S. Treasury, corporate and municipal bonds. For example, the screener allows you to find all the publicly-traded bonds of a company, as well as detailed information about each of its individual bond issues. It also allows you to screen for a list of bonds that meet certain criteria, such as yield ranges, maturities and credit ratings.

The Bond Center home page also provides summary data on daily corporate bond trading activity, including performance data on two key benchmarks: the [FINRA/Bloomberg Investment Grade Index](#) and the [FINRA/Bloomberg High Yield Index](#). It also gives a list of the day's most actively-traded corporate bonds, which is carried in the pages of most major business newspapers. Performance data on the FINRA/Bloomberg benchmarks is reported daily in the financial pages of the **New York Times**.

Through the Bond Center, investors can also view detailed information about the FINRA/Bloomberg benchmarks, including a list of all of the bonds that comprise each index (with links to recent trading activity on each bond).

Watchlist. One of the Market Data section's most useful features is the Watchlist, which allows you to get current pricing on your own personal list of U.S. Treasury, corporate and municipal bonds all on one page.

The Wall St. Journal and The Wall St. Journal Online www.wsj.com – (subscription required) Read the Credit Markets column in daily Wall St. Journal to keep track of activity in the U.S. Treasury markets and also major news in other sectors, especially corporate bonds. The Markets Data section of the Wall St. Journal Online provides a variety of daily statistics on the bond market and various sectors within it. For example, you can get yields and spreads on a number of indexes, such as the Lehman BBB U.S. Corporate and Merrill Lynch High Yield indexes.

Barron's and BarronsOnline www.barrons.com (subscription required) also offers some useful tools including its weekly Current Yield column and bond market statistics. On the web site, you can also see a weekly list of bond rating upgrades and downgrades.

U.S. Treasury – Daily Treasury Yield Curve The U.S. Treasury offers daily closing yields on Treasury securities ranging from 1-month T-Bills to 30-year Treasury bonds at <http://www.treasury.gov/offices/domestic-finance/debt-management/interest-rate/yield.html>. The site includes historical yield curve levels going back for many years.

TreasuryDirect.gov This is the website of the U.S. Treasury Dept. which allows you to purchase and sell U.S. Treasury securities and savings bonds directly from the government, with no commission. It also provides information about U.S. Treasury securities, including the results of recent offerings and, for example, the detailed inflation-adjustment calculations on TIPS.

U.S. Federal Reserve has a number of economic reports and detailed interest rate statistics available on its website at www.federalreserve.gov. A wide range of daily and weekly interest rates from commercial paper to Treasuries to swap rates is available. The site also provides the text of the messages accompany decisions of the Federal Open Market Committee and major speeches by Federal Reserve Board members.

CUSIP Service Bureau The Committee on Uniform Securities Identification Procedures assigns a number to every publicly-traded U.S. security. This is known as the CUSIP number. Standard & Poor's maintains the site, which is located at: <http://www.isin.cusip.com/IsinServiceLogin.jsp>. If you are looking to buy a specific bond, brokers will often ask you for the CUSIP number. The site is free, but requires registration. (Before recent changes, you could get the CUSIP number from the FINRA.org BondCenter. Now, the site no longer provides you with the CUSIP, but you can still search for bond information by CUSIP number.)

Ratings Agency Websites All of the credit ratings agencies have websites that offer free content provided that you register. Moody's and Standard & Poor's generally limit the amount of information available for free. However, Fitch Ratings offers a surprisingly large amount of free content, which is usually quite good.

Fitch Ratings	www.fitchratings.com
Moody's	www.moodys.com
Standard & Poor'	www.standardandpoors.com

Investing in Bonds www.investinginbonds.com Sponsored by the Securities Industry and Financial Markets Association, this web site offers much of the same pricing information available on the finra.org web site and much more. For example, it offers performance charts on several bond indexes and periodic market commentary on the municipal, government and corporate sectors. It also has a bond calculator and other resources that are useful to those learning about bonds.

Bonds Online Group The Group has several website devoted to fixed income investors. I must confess that I find the content here to be pretty disappointing. However, the Group has a newsletter, Yield and Income, which provides a summary of the fixed income and equity strategies recommended by the major broker firms, so it might be useful. Its websites include:

www.bondsonline.com
www.epreferreds.com
www.bondsonlinequotes.com
www.yieldandincome.com

Bloomberg The purveyor of the Bloomberg terminal, which is the life source of institutional fixed income investors, Bloomberg is also a news service and media provider. Bloomberg Television and Bloomberg Radio produce programs and stories that are of great interest to fixed income investors. On its website, Bloomberg provides some useful fixed income news and data, including:

Bond market news and rates: <http://www.bloomberg.com/markets/rates/index.html>

Corporate bonds: <http://www.bloomberg.com/markets/rates/corpbonds.html>

podcasts of "On The Economy", a daily (M-F) radio program with host Tom Keene:

<http://www.bloomberg.com/tvradio/podcast/ontheeconomy.html>

Quantum Online www.quantumonline.com A free website (registration required) which that provides info on preferred stocks, closed-end funds and exchange-traded fixed income securities. The site gives links to the prospectus of each preferred stock offering, for example.

Advantage Data. www.advantagedata.com. This is a bond pricing service primarily for institutional investors. It offers pricing on investment grade, high yield and convertible bonds. It also provides access to fixed income research from brokerage firms and independent research providers. The service is not cheap. (Last I heard, it runs several hundred dollars per month.) But if you are into some heavy duty fixed income investing, it is a much less expensive source than some services offered by Bloomberg and Reuters, for example.

Recommended Reading: (Required reading for those new to fixed income investing)

These books offer good background information and many useful tips for following the bond markets and investing in fixed income securities.

The Strategic Bond Investor by Anthony Crescenzi, McGraw-Hill, 2002. This book provides an excellent overview of various bond market sectors and their importance. It gives clear and easily understandable descriptions of key concepts, such as the yield curve and real interest rates. It gives you many of the tools that you need to make strategic decisions about determining fixed income sector weightings in your portfolio. It does not, however, offer all that much help in determining how to analyze and select individual bonds. The book is very well written. Although it repeats many of its major points and descriptions several times in some instances, that repetition can be useful in driving home its points for those who are new to fixed income investing. The book needs to be updated, but most of the concepts that it covers are still quite relevant today..

Bonds: The Unbeaten Path to Secure Investment Growth by Hildy Richelson and Stan Richelson, Bloomberg Press, 2007 (2nd edition) Although I disagree with the authors' suggestion that you can't lose any money by investing in high quality bonds, I believe strongly in their assertion that an all-bond portfolio can provide attractive returns at much lower risk than a stock-based strategy. It therefore makes great sense for many investors to pursue such a strategy, especially in these uncertain times. The book's primary strength, in my view, is its description of the bond buying process, tax considerations and its advice on working with brokers. It gives useful tips for investors considering bond mutual funds. It also offers practical suggestions on how to structure a bond portfolio. But like Mr. Crescenzi's book, it does not provide a lot of information about how to analyze and select individual bonds.

SOME THOUGHTS ON BUYING BONDS AND WORKING WITH BROKERS

Although it is now possible to purchase bonds from discount brokers as well as full service brokers, the process is quite different from buying stocks. Unlike stocks, bonds do not trade on a central exchange. (The NYSE, which has provided an exchange platform for trading bonds for many years, recently upgraded and expanded its capabilities, but trading volume there has plummeted, in part because it raised its trading fees sharply.)

Without a central exchange, full service brokers have traditionally offered bonds to their clients out of their own inventories. They can often find other bonds through the interdealer market, but prices paid there can be high, since two brokers are looking to earn a profit from the sale.

Bonds are quoted by bid and offer spreads. The bid price is what a broker will pay; the offer price what it will sell. Often the spreads are quoted in terms of yield. Actively traded markets, such as the one for U.S. Treasury bonds, typically operate with a very small spread of only 1/32 of a point or \$0.31 cents per bond. However, some bonds trade by appointment only, so the bid-offer spreads can be quite high, sometimes a full point (equal to \$10 per bond) or more.

Besides the quote spread, many online brokerages charge a commission rate per bond. According to the Richelsons (See Recommended Reading on the previous page) Fidelity charges \$1 to \$4 per bond; but some online brokers, such as Zion Direct and TD Ameritrade charge a flat fee.

Most of the trading platforms available from discount brokers collect quotes from various brokers, but the offerings may be indications only and are not always firm. You won't know whether an offering that you see online is firm until you place an order; so it is possible that your order won't be filled at the indicated price. Hopefully, as fixed income trading volume through online brokers increases, this will be less of a problem.

Nevertheless, it is probably best, especially if you are new to fixed income investing (and even if you are not) to work directly with a broker. Many of the larger discount brokerage firms have fixed income trading desks. If you are an active fixed income trader, it is likely that you will get to know their salesmen and traders.

Alternatively, all of the largest brokerage firms and many of the large regional brokerages have active fixed income trading desks.

Working directly with a salesman will not only bring you up the learning curve faster, it should also give you access to better investment opportunities over time. Still, you may want to work with more than one broker, if your portfolio is large enough, or you may want to use web-based price quotes and recent trade prices (from TRACE) as a check against your broker's offerings.

Since there are literally thousands of bond issues in the corporate and municipal sectors, you may not always be able to find the exact bond issue that you have targeted for purchase. For that reason, I believe that it is probably best to identify desirable bond issuers first, like General Mills, for example, on the corporate side, or the State of Massachusetts, say, on the municipal side. Once you have identified the target issuers, you should select several bonds of certain classes and maturities, like, say, senior unsecured notes with 4-7 year maturities, and also determine a minimum acceptable yield that you expect to earn on any bond purchased. With large issuers, you should be able to find several bonds that fit your investment parameters; but you should also check to make sure that the terms of those bonds, such as call provisions and covenants, are similar.

So, you may want to buy the issuer's 5.25% Senior Notes due 2011, but your broker may only be able to find (or may be able to get you a better price on) the 5.75% Senior Notes due 2013. Similarly, you may only want to buy 25 bonds (i.e. \$25,000 face amount) of those bonds, but the broker may be able to get you a much better deal, if you buy 32 of those bonds (because it would allow him to clear out an existing odd lot position, for example).

Thus, you should have a firm grasp on your investing parameters, but have the flexibility to work with your broker to find the best deal. Such an operating strategy may help to ensure success in bond investing. This is the primary reason why it is useful to work directly with your broker's representative.

For more information about working with brokers, see the Richelson's book, "Bonds: The Unbeaten Path to Secure Investment Growth." Alternatively, you can see a summary of their comments on this subject in their article, "How to Buy Individual Bonds: A Fixed-Income Toolkit," in the February 2008 issue of the AAI Journal, available to members of the American Association of Individual Investors at www.aaai.com.

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