

To Your Wealth Update

News & information to contribute to your financial peace of mind



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Risky bonds

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Most people have heard that bonds are less risky than stocks. While this is typically true, it doesn't mean bonds are risk-free. Now that interest rates are as low as they were in the 1950s, one risk that bond investors should be aware of is the impact of rising interest rates on the values of existing bonds.



A bond is essentially an IOU in which you lend money in return for interest plus the original amount back at the end of a specific period of time. There is an inverse relationship between the

price of bonds and interest rates. Imagine a seesaw on a playground with bond prices at one end and interest rates at the other. As one goes up, the other goes down.

Another way to understand interest rate risk is through an example. If you buy a bond this year for \$100 which pays 3 percent interest and want to sell it in a year when rates are 4 percent, the only way to entice someone to buy your lower interest paying bond is to sell it at a lower price. If 4 percent bonds were also selling for \$100 per bond, you might have to sell your bond for \$95 in order to convince someone to take your 3 percent interest. This \$5 difference in price is the loss you experience for selling your bond when rates increased.

Bond investors use a concept called duration to determine the amount of price fluctuation they would experience if interest rates were to rise or fall by 1 percent. For instance, a duration of 5 years means that a 1 percent increase in interest rates would result in a 5 percent decrease in price, similar to the example above. While the calculation to determine duration is beyond the scope of this column, there are sources to find the duration for individual bonds and even bond mutual funds. In particular, Morningstar (www.morningstar.com) provides the duration for most bond funds plus a variety of other statistics.

Even with the possibility of losses, bonds are still an important part of a balanced portfolio because they will lower the volatility of an all stock portfolio. One way to reduce the impact of rising interest rates is to hold shorter term bonds. Many bond investors will also hold their bonds until maturity so they don't have to sell them at a lower price. While this avoids the reduction in price, they still miss out on the higher interest rates that would have been available. Knowing the impact of interest rate movements on the value of your bonds will help explain some of the future fluctuations you will experience as an investor.



The Next Tech Bubble?

Those of us who watched the LinkedIn initial public offering experienced a strange sense of déjà vu. The social media company was offered to the public at \$45 a share, and an unexpected buying frenzy took the price up 171% on the first day of trading, before the company settled back to just over \$94 a share--more than 109% above the offering price. By that valuation, the Mountain View, CA company is worth nearly \$9 billion, more than the Harley Davidson motorcycle manufacturer and Moodys Corp., the rating agency. Does anybody hear echoes of the Dot-Com bubble, when shares of Amazon.com were briefly trading at a valuation greater than the gross domestic product of Iceland?

A recent article in The Economist says that we are indeed flirting with a new tech bubble. Secondary market trading in Facebook (which is not publicly listed) values it at roughly \$76 billion, more than Boeing or Ford Motor Corp. Microsoft recently purchased Skype, the internet calling and video service, for \$8.5 billion, about ten times its sales last year and 400 times its operating income. A photo-sharing social network called Color was recently said to be worth \$100 million, although its service is as yet untested.

A longer evaluation in the same issue of The Economist points out some other similarities to the Tech Bubble. For one, there IS an underlying digital revolution going on. Apple's App Store now offers 300,000 apps, which are being installed at the rate of 20 million a day. Like the earlier boom in tech stocks, this one is being fueled, in the early stages, by eager venture investors who see the potential and want to be the first dollars in on the action. The Centre for Venture Research at the University of New Hampshire estimates that \$20 billion in angel investing took place in 2010. American hedge

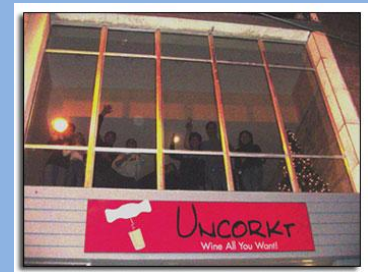
funds, private-equity firms and some mutual funds are following in their footsteps.

As we've seen in past investment bubbles, the enthusiasm starts to feed on itself, valuations go through the roof, analysts start to create alternative valuation measures which pay little attention to actual earnings or return on capital, and people start talking about their stocks at the post office and barber shop. Then, at some point, the music stops, and those who participated in the frenzy wake up with a hangover in their portfolio. It's an old story, replayed again and again.

Save the date for our next Appreciation Event!

Reserve August 5 -
6 p.m. to 8 p.m.

We thought it would be fun to host you at *UnCork* (240 Main Street) for a casual private event



during Racine's final First Friday for the season. We'll be sending additional information as the date nears, so mark your calendar today and plan to join us on August 5 for wine tasting and snacks during First Fridays.

Upcoming workshop - August 9, 6:30 p.m. to 8 p.m. – *The Process of Transition: Planning & Managing Inevitable Change*

In today's world, change is inevitable and constant. This workshop will be facilitated by Tami Witt and will explore phases of change and the accompanying transitions that occur regardless of the nature of the change.