

Climb a 'Bond Ladder' As Interest Rates Rise

For bond and certificate-of-deposit investors, today's rising interest rates are good news/bad news. One strategy many financial planners have long recommended for handling rising interest rates is the bond ladder.

To understand why a bond ladder works, think of a seesaw. When interest rates rise, the value or price of a bond falls below its par or face value (assuming the current owner bought it new). That's because other investors aren't willing to pay the face value of the bond when they can invest the same amount of money in a similar new bond paying higher interest.

The reverse happens in a falling interest-rate environment. Investors are willing to pay more for an existing bond that hasn't reached its maturity in order to hang onto higher interest rates. The longer the maturity of a bond, the faster the price of the bond falls or rises in relationship to changing interest rates. Of course, if you hold onto individual bonds until they mature, you should receive their face value (unless there's a default) regardless of any price changes during the holding period.

That's why rising interest rates are good news/bad news for investors. On the one hand, they like the idea of earning more interest on their bonds, especially in the wake of such low rates for so many years. Between the summer of 2004 and April 2005, the Federal Reserve raised short-term rates from 1 percent to 2.75 percent, and most observers expect the Fed to continue to raise rates for a while.

But that's where the bad news comes in. Investors are reluctant to buy anything but short-term bonds and CDs because they don't want their money tied up long term should interest rates continue to rise. They also don't want to risk being in longer-term bonds and watching the prices be punished should rates climb (the price of a CD you already own won't change when general interest rates change).

Yet longer-term securities usually pay more interest than shorter-term securities. That's where the bond ladder can help, because it reduces the risk of interest-rate changes while allowing you to take advantage of higher rates. Here's how it works.

You buy individual bonds or CDs with a mix of maturities. For example, you might buy roughly equal dollar amounts of various U.S. Treasury securities, with each maturity date representing a different rung on the ladder. In April, the yield on three-month Treasury bills was approximately 2.8 percent, six-month bills yielded 3.1 percent, two-year notes yielded 3.5 percent, five-year notes yielded 3.9 percent, and ten-year Treasury notes brought 4.2 percent.

When the shortest-term security matures on the bottom rung of the ladder, reinvest the proceeds in the best-returning rung, which usually is the top rung of securities with the longest maturity. In time, the shorter-maturity, lower-paying rungs will be gradually replaced by higher-paying, longer-maturity securities.

Why not just buy the higher-paying, longest-maturity securities in the first place? Because by using the ladder approach you always have some securities maturing every few months or every year, depending on how you construct your ladder. This enables you to reinvest matured

securities at the highest available rate, or cash them in without risk of loss of principal should you need the funds.

You can build ladders out of most types of securities, such as Treasuries, corporate bonds, CDs, and municipal bonds, depending on what's appropriate for you and what level of risk you're willing to take. You also can build your ladder only as far out in maturity as you feel comfortable or that you need. Perhaps you only want to go out five or seven years instead of ten or longer.

The general advice is that you need a minimum of \$100,000 in order to cost-effectively buy sufficient numbers of individual bonds to build an effective ladder (transaction costs are not an issue for CDs).

If you don't have enough to invest in a ladder of individual securities, it's possible but more difficult to build a ladder out of bond mutual funds. The problem with funds is that they usually have no definite maturity date and individual investors can't control redemptions. But some funds focus on bonds with certain maturities, such as ultra-short, short, intermediate, or long-term bonds, so you could build a rough version of a bond ladder.

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