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About New Wealth Advisors.

New Wealth Advisors is an independent, fee-only, SEC-registered investment advisor, operating as a multi-family investment office. We work with newly wealthy individuals and families to protect, grow and manage assets.

Bonds, Interest Rates, and the Impact of Inflation

There are two fundamental ways that you can profit from owning bonds: from the interest that bonds pay, or from any increase in the bond's price. Many people who invest in bonds because they want a steady stream of income are surprised to learn that bond prices can fluctuate, just as they do with any security traded in the secondary market. If you sell a bond before its maturity date, you may get more than its face value; you could also receive less if you must sell when bond prices are down. The closer the bond is to its maturity date, the closer to its face value the price is likely to be.

Though the ups and downs of the bond market are not usually as dramatic as the movements of the stock market, they can still have a significant impact on your overall return. If you're considering investing in bonds, either directly or through a mutual fund or exchange-traded fund, it's important to understand how bonds behave and what can affect your investment in them.

The price-yield seesaw and interest rates

Just as a bond's price can fluctuate, so can its yield--its overall percentage rate of return on your investment at any given time. A typical bond's coupon rate--the annual interest rate it pays--is fixed. However, the yield isn't, because the yield percentage depends not only on a bond's coupon rate but also on changes in its price.

Both bond prices and yields go up and down, but there's an important rule to remember about the relationship between the two: They move in opposite directions, much like a seesaw. When a bond's price goes up, its yield goes down, even though the coupon rate hasn't changed. The opposite is true as well: When a bond's price drops, its yield goes up.

That's true not only for individual bonds but also the bond market as a whole. When bond prices rise, yields in general fall, and vice versa.

What moves the seesaw?

In some cases, a bond's price is affected by something that is unique to its issuer--for example, a change in the bond's rating. However, other factors have an impact on all bonds. The twin factors that affect a bond's price are inflation and changing interest rates. A rise in either interest rates or the inflation rate will tend to cause bond prices to drop. Inflation and interest rates behave similarly to bond yields, moving in the opposite direction from bond prices.

If inflation means higher prices, why do bond prices drop?

The answer has to do with the relative value of the interest that a specific bond pays. Rising prices over time reduce the purchasing power of each interest payment a bond makes. Let's say a five-year bond pays $400 every six months. Inflation means that $400 will buy less five years from now. When investors worry that a bond's yield won't keep up with the rising costs of inflation, the price of the bond drops because there is less investor demand for it.

Why watch the Fed?

Inflation also affects interest rates. If you've heard a news commentator talk about the Federal Reserve Board raising or lowering interest rates, you may not have paid much attention unless you were about to buy a house or take out a loan. However, the Fed's decisions on interest rates can also have an impact on the market value of your bonds.

The Fed takes an active role in trying to prevent inflation from spiraling out of control. When the Fed gets concerned that the rate of inflation is rising, it may decide to raise interest rates. Why? To try to slow the economy by making it more expensive to borrow money. For example, when interest rates on mortgages go up, fewer people can afford to buy homes. That tends to dampen the housing market, which in turn can affect the economy.

When the Fed raises its target interest rate, other interest rates and bond yields typically rise as well. That's because bond issuers must pay a competitive interest rate to get people to buy their bonds. New bonds paying higher interest rates mean existing bonds with lower rates are less valuable. Prices of existing bonds fall.

That's why bond prices can drop even though the economy may be growing. An overheated economy can lead to inflation, and investors begin to worry that the Fed may have to raise interest rates, which would hurt bond prices even though yields are higher.

Falling interest rates: good news, bad news

Just the opposite happens when interest rates are falling. When rates are dropping, bonds issued today will typically pay a lower interest rate than similar bonds issued when rates were higher. Those older bonds with higher yields become more valuable to investors, who are willing to pay a higher price to get that greater income stream. As a result, prices for existing bonds with higher interest rates tend to rise.

Example: *Jane buys a newly issued 10-year corporate bond that has a 4% coupon rate--that is, its annual payments equal 4% of the bond's principal. Three years later, she wants to sell the bond. However, interest rates have risen; corporate bonds being issued now are paying interest rates of 6%. As a result, investors won't pay Jane as much for her bond, since they could buy a newer bond that would pay them more interest. If interest rates later begin to fall, the value of Jane's bond would rise again--especially if interest rates fall below 4%.*

When interest rates begin to drop, it's often because the Fed believes the economy has begun to slow. That may or may not be good for bonds.The good news: Bond prices may go up. However, a slowing economy also increases the chance that some borrowers may default on their bonds. Also, when interest rates fall, some bond issuers may redeem existing debt and issue new bonds at a lower interest rate, just as you might refinance a mortgage. If you plan to reinvest any of your bond income, it may be a challenge to generate the same amount of income without adjusting your investment strategy.

All bond investments are not alike

Inflation and interest rate changes don't affect all bonds equally. Under normal conditions, short-term interest rates may feel the effects of any Fed action almost immediately, but longer-term bonds likely will see the greatest price changes. Also, a bond mutual fund may be affected somewhat differently than an individual bond. For example, a bond fund's manager may be able to alter the fund's holdings to minimize the impact of rate changes. Your financial professional may do something similar if you hold individual bonds.

Focus on your goals, not on interest rates alone

Though it's useful to understand generally how bond prices are influenced by interest rates and inflation, it probably doesn't make sense to obsess over what the Fed's next decision will be. Interest rate cycles tend to occur over months and even years. Also, the relationship between interest rates, inflation, and bond prices is complex, and can be affected by factors other than the ones outlined here.

Your bond investments need to be tailored to your individual financial goals, and take into account your other investments. The financial professionals at New Wealth Advisors can help you design your portfolio to accommodate changing economic circumstances.

The inflation/interest rate cycle at a glance

- Inflation goes up.
- Bondholders worry that the interest they're paid won't buy as much in the future because inflation is driving costs higher.
- The Fed may decide to raise interest rates to try to control inflation. To get investors to lend money by purchasing bonds, bond issuers must pay higher interest rates.
- When interest rates go up, bond prices go down.
- Higher interest rates make borrowing money more expensive. Economic growth tends to slow, which means less spending.
- With less demand for goods and services, inflation levels off or falls.
- With lower inflation, bond investors are less worried about the future purchasing power of the interest they receive. Therefore, they may be willing to accept lower interest rates on bonds, and prices of older bonds with higher interest rates tend to rise.
- Interest rates in general fall, fueling economic growth and potentially a new round of inflation.

Investing in a Low Interest Rate Environment

Low interest rates create a dilemma. Do you accept a low return because you feel you must protect your principal? Or do you take on greater investment risk in order to try for a higher return? In balancing those two concerns, here are some factors to think about.

Consider laddering your CDs

When yields on Treasury bonds began dropping last year, many investors were attracted to certificates of deposit (CDs) offered by banks that needed to attract capital. However, interest rates won't stay low forever, and at some point you may want access to your money before a CD matures. One way to achieve higher rates while retaining flexibility to adjust your strategy over time is to ladder CDs. Laddering involves investing in CDs with varying maturity dates. As the shorter-term CDs mature, you can reinvest in one with a longer term and higher rate. Over time, laddering can give you both the higher rates typically offered by longer-term CDs and the ability to adjust as interest rates change.

Pay attention to expenses

Low returns magnify the impact of high investing expenses. Let's say a mutual fund has an expense ratio of 1.00, meaning that 1% of its net asset value each year is used to pay operating expenses such as management and marketing fees. That 1% represents a bigger relative bite out of your return when the fund is earning 3% than it does if it's earning 10%. At the higher number, you're losing only about 10% of your return; at 3%, almost a third of your return goes to expenses. Before investing in a mutual fund, carefully consider its fees and expenses as well as its investment objective and risks, which can be found in the prospectus available from the fund. Read the prospectus carefully before investing.

Think about your real return

Low interest rates may not be quite as problematic as they seem. Even if you're earning a low interest rate, your real return might not suffer too much if inflation is also low. Real return represents what your money earns once the impact of inflation is taken into account. With an annual inflation rate of 0.1%--the December 2008 Consumer Price Index (CPI) figure--a bond that pays 3% would produce the same real return as a bond that pays 5% when annual inflation is running at 2.1%.

Compare interest rate and yield spreads

When market instability drove many investors to the safety of Treasury bonds, their prices rose and yields fell. As a result, the spreads between Treasury yields and those of corporates and municipals have been relatively high over the last year because non-Treasury bonds have to offer higher yields to compensate for investors' anxiety about the safety of their principal and possibility of default.

Consider small changes

You may not need to remake your portfolio completely to seek a higher return. For example, if you're in Treasuries, you could move part of that money to municipal bonds, which may involve greater risk of default but whose net returns are boosted by their exemption from federal income tax. Or you could shift a portion of your stock allocation to dividend-oriented stocks and ETFs, or preferred stock.

Look for buying or selling opportunities

Interest rates also can be used to help evaluate equities. Some analysts like to determine the relative value of the stock market using the so-called Fed market valuation model. The model compares the earnings yield on the S&P 500 to the 10-year Treasury bond's yield. If the S&P's yield is higher than the T-bond's, the model considers the market undervalued relative to bonds. If the Treasury yield is higher, the market is overvalued. However, this is only one of many valuation models and shouldn't be the sole factor in your decision.

Don't stop at yield

If you're tempted to seek a higher return, don't forget that yield alone shouldn't be your only criterion. In reaching for additional yield, you may be taking on additional risk. Also, if and when interest rates rise, the change may affect a bond's market value unless held to maturity. Don't hesitate to get expert help to assess whether you can increase your return without taking on more risk than you can afford.

Teach Your Children Well: Financial Tips for Teens

Today's teens have more money to spend and more opportunities to spend it, and if they're not careful, they can easily get into financial trouble. Before that happens to your teen, help him or her learn a few financial lessons.

Earning wages

If you think your teen is ready, encourage him or her to get a part-time job. Here are some things to discuss once your teen begins working:

- Agree on what your child's pay should be used for
- Show your teen how taxes reduce take-home pay
- Open a checking and savings account for your teen, and encourage him or her to save a portion of every paycheck before spending any of it

Keeping a balanced budget

To develop a balanced budget, have your teen list all his or her income. Next, list common expenses, such as food and gas (don't include things you will pay for). Finally, subtract the expenses from the income. If the results show that your teen will be in the red, you'll need to come up with a plan to address the shortfall. To help your teen learn about budgeting:

- Devise a system for keeping track of what's spent
- Suggest thinking through spending decisions rather than buying on impulse
- Categorize expenses as needs (unavoidable) and wants (that can be cut)
- Suggest ways to increase income (like doing extra chores) and/or reduce expenses

The future is now

An older teen should be ready to focus on saving for larger goals (e.g., a new computer or a car) and longer-term goals (e.g., college, an apartment). Here are some ways to encourage saving for the future:

- Have your teen put the goals in writing to make them more concrete
- Encourage your child to save for what he or she wants, not what other kids have
- Praise your child for showing responsibility in meeting a goal

To introduce your teen to investing, open an investment account for him or her. (If your teen's a minor, this must be a custodial account.) Look for an account that can be opened with a low initial contribution at an institution that supplies educational materials about basic investment terms and concepts.

Should you give the kid credit?

If your teen is responsible, you might consider getting him or her a credit card. Most major credit card companies require an adult to cosign a credit card agreement before they will issue a card to someone under the age of 18. Ask the credit card company for a low credit limit (e.g., $300) or a secured card. This can help your child learn to manage credit without getting into serious debt. Also:

- Set limits with your teen on the card's use
- Make sure your child understands the grace period, fee structure, and how interest accrues on the unpaid balance
- Agree on how the bill will be paid, and what will happen if your child can't pay the bill
- Make sure your child understands how long it will take to pay off a credit card balance if he or she only makes minimum payments

ASK THE EXPERTS

Can I open a 529 account in anticipation of my future grandchild?

No, not if you intend to name your future grandchild as beneficiary. A valid 529 beneficiary has to have a Social Security number, so it's not possible to name a child who hasn't been born. But there is a way to open a 529 account that eventually can be turned over to a future grandchild.

Your first step is to open a 529 account and name a beneficiary who is a "family member" of your future grandchild. Then, when your grandchild is born, you, as account owner, can change the beneficiary to your grandchild. All 529 plans have mechanisms in place for changing the beneficiary.

According to IRS Publication 970, Tax Benefits for Education, there are no income tax consequences if the beneficiary of a 529 plan account is changed to a "family member" of the original beneficiary. This includes the beneficiary's (1) spouse, (2) son, daughter, stepchild, foster child, adopted child or descendant of any of them, (3) sibling or stepsibling, (4) parent or ancestor of either, (5) step-parent, (6) niece or nephew, (7) aunt or uncle, (8) daughter-in-law, son-in-law, mother-in-law, father-in-law, sister-in-law, or brother-in-law, (9) the spouse of any person listed, and (10) first cousin. Changing the beneficiary could have gift tax consequences, though.

However, carefully check the details of any 529 plan you're considering before you name the initial beneficiary. Some plans impose age restrictions on the beneficiary, such as requiring that the beneficiary be under age 21. Such a restriction could pose a problem if you intend to name your adult son or daughter as the initial beneficiary.

Other plans may have rules that indirectly impact who you can choose as your initial beneficiary, such as a requirement that the funds in the account be spent within 10 years of when the initial beneficiary would be expected to enter college. You don't want to be surprised by a technicality.

Can more than one 529 plan account be opened for the same beneficiary?

Yes. You (or anyone else) can open multiple 529 accounts for the same beneficiary, provided you do so under different 529 plans.

For example, you could open three 529 college savings plan accounts for your daughter: one in State A, one in State B, and one in State C. Similarly, you could open accounts in States A and B for your daughter, and another relative could open an account for her in State C. Or, you could open a 529 college savings plan account and a 529 prepaid tuition plan account for your daughter in State A. But you can't open two college savings plan accounts (or two prepaid tuition plan accounts) in State A for the same beneficiary.

If you do open multiple 529 accounts for the same beneficiary, keep in mind that each plan has its own contribution limit, and contributions can't be made after the limit is reached.

However, some states consider the accounts in other states to determine whether the limit has been reached. For these states, the total balance of all plans (in all states) can't exceed the current year's maximum contribution amount.

Also, keep in mind that each 529 plan will have its own investment options and flexibility, contribution rules, ownership and beneficiary designation rules, costs and fees, and ability to perform account management tasks online.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

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