

Bond Shopping Guide



There are a variety of bonds from plain to the exotic, broad to the specific. You can buy bonds individually. You can also buy bond mutual funds and Exchange Traded Funds. We'll discuss the more typical bonds. And we'll also discuss some options and strategies for buying and selling them.

Treasuries

Technically speaking, U.S. Treasuries with maturities of 30 days to 1-year are "bills"; 2, 5 and 7-year maturities are "notes"; 10-year and greater maturities are "bonds". As a group, they're often referred to as "Treasuries".

Treasuries are the debt obligation of the U.S. Government. They're backed by the "full faith and credit of the U.S." and considered the safest investment in the world (after all, the government can just raise taxes and print money if needed. Its "budget" isn't nearly as restrictive as a regular person's budget).

Given the high degree of safety, interest rates - or "yields" - tend to be lower than comparable maturities of other bonds. Income earned from Treasuries frequently is exempt from state and local taxes - which can partially offset the lower yield.

The U.S. Treasury is the largest issuer of debt in the world with \$4.8 trillion (yes, with a T) outstanding as of September 30, 2006.

You can buy Treasuries directly from the Treasury Department, through the "Treasury Direct" program by opening up an account with the U.S. Dept of the Treasury. You can also buy them through brokerages and many commercial banks.

The secondary market for Treasuries is also very liquid should you want to sell rather than hold them to maturity.

Individual investors do hold Treasuries, but they are largely held by institutional buyers both domestic and foreign. In some cases they're purchased for the dependable income stream by pension and endowment funds for instance. In other cases they may be purchased to "hedge" or offset a business risk by home mortgage lenders and insurance companies for example.

Municipal Bonds

Next step up on the risk scale are Municipal Bonds abbreviated as "Munis". These bonds are issued by state, city and local districts to fund public works projects.

Community projects such as schools, government office buildings and courthouses are typically funded by general obligation bonds which are repaid with tax revenue.

Use projects such as airports, utilities and roads are generally funded by revenue bonds and repaid with fees collected on the services.

Munis are considered second only to Treasuries in safety. Additionally, income earned is exempt from Federal, State and often local taxes for holders that live in the community. Due to the low risk and tax advantage, interest rates tend to be about 25% lower than comparable corporate bonds.

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This market is also large and liquid with a daily trading volume estimated at \$11 billion and approximately \$1.7 trillion outstanding.

There are more individual investor participants in the Muni market primarily because of the tax advantage. It's estimated that individuals investing directly or through funds hold about 74% of the outstanding Muni debt.

Muni bonds are typically sold in increments of \$5,000 to individuals and can be purchased through brokerages and banks.

Federal Agency and Government Sponsored Enterprise Bonds

Government Sponsored Enterprises (GSE) were created primarily to fund various public policy concerns. GSEs provide credit in the housing, agricultural, small business and student loan markets. The more well-known GSEs are Fannie Mae (housing), Freddie Mac (housing), Farmer Mac (agricultural) and Sallie Mae (student loans).

It's a large market with about \$845 billion in outstanding debt and attracts primarily institutional and foreign investors.

GSEs benefit from an *implied* guarantee, but not all are backed by the "full faith and credit" of the U.S. Government. Like any other independent entity, these entities stand on their own. However, given that their perceived risk is lower than a comparable corporation; their yield is not much greater than Treasuries. GSE debt is generally rated AAA to AA-

GSE bonds can be purchased through brokerages and some commercial banks.

Corporate Bonds

Corporate bond issuers include public utilities, transportation companies and the full gamut of public and private corporations.

The credit quality of the bond issuer is used to gauge the risk. Investment class bonds carry a grade of AAA to BBB. Speculative or High-Yield (a.k.a. "junk") class bonds carry a grade of BB to CC. C and D graded bonds are not meeting the original terms of the bond.

The greater the risk, generally the higher the yield. Yields on the highest rated bonds (AAA) are higher than Treasury yields and income earned from bonds is fully taxed.

Corporate bonds primarily trade electronically or by phone in the over-the-counter market (OTC) which is made up of bond dealers. Bonds are generally sold in multiples of \$1,000 or \$5,000. They may have "Call" provisions which means they can be repaid before the maturity date (see "*Bond Market: Risk... What Risk*" for a more detailed explanation).

The market is large, trading over \$20 billion a day with over \$4 trillion in outstanding bonds.

Speculative or High-Yield Bonds

The High-Yield market flourished in the 1970s to fund start-up companies and leveraged buy outs. It still works well for those issuers as well as high debt companies, capital intensive companies, formerly investment class companies (fallen angels) and foreign companies.

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The average new issue is around \$200 million. Maturities are generally 10 years or less. These bonds may have a "call" provision.

High-Yield bonds have a greater risk of both default and credit downgrade; therefore, they also tend to have a more exaggerated reaction to economic downturns as the default rate for these bonds rises in tough economic times.

The market in general is not as liquid as the corporate or government markets and specific bonds may become illiquid if risk factors or market conditions change.

High-Yield bonds can add diversity to your portfolio and increase the return, but it's important to not lose sight of the risk.

Bond Funds

You can buy bonds individually and you can also buy bond funds. Same market, different characteristics.

Bond funds - like stock funds - generally have a specific investment objective. The objective might be centered on current income, maturity range (ex: 2-year, 5-year, 10-year) or type of bond (ex: Treasuries, Corporates, High-Yield, International).

The primary attraction of a bond fund is convenience. And like most else in life, that comes with advantages and disadvantages.

With a bond fund often you can invest any amount. Individual bonds typically require multiples of \$1,000 or \$5,000. A fund can be more affordable and generally, your dividends can be reinvested.

Professionals with experience and access to more research are often better at bond selection and maintenance of a portfolio than individuals.

Diversification is much easier with funds. Fund managers can spread interest rate risk, credit risk, sector risk, and maturity risk as well as specific bond issue risk. The individual investor can more easily allocate their capital across funds with different objectives to achieve diversity with much lower capital and effort, even if you purchase just one fund.

Bond funds usually make monthly or quarterly dividend payments as compared to semi-annual interest payments common with most bonds.

Funds have a management fee and other internal expenses which will reduce your return.

Individual bonds have a date certain for maturity as well as a known interest rate. Bond funds typically maintain a relatively constant maturity by buying and selling bonds in the fund. Because the mix of bonds in the fund is constantly changing, so is the yield.

Also, because the bonds are constantly changing in the fund, so is the risk-return profile.

An individual bond carries with it a contractual obligation to the holder for return of principal and payment of interest. Shares in a bond fund do not.

In addition to the characteristics listed above, there are a few specifics to be aware of when choosing a bond fund...

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Open-end or Closed?

Open-end funds allow you to buy and sell shares from the fund whenever you choose. Share prices in funds are based on their Net Asset Value (NAV) which is simply the market value of the bonds in the fund divided by the number of shares in the fund.

When money comes into the fund, i.e., when people buy shares, the fund manager buys more bonds. When people redeem (sell) their shares, the manager sells bonds from the fund to generate cash. The manager may also buy and sell bonds to maintain the fund's objective

Closed funds have a specific number of shares. This makes the fund more stable and easier to manage but it means that it may trade at discount from its NAV, and you generally buy and sell shares only in the open market.

Active or Indexed?

Actively managed funds have managers that buy and sell around the fund objective. Their goal is to beat a specific benchmark.

Index funds are designed to match a given index such as the Ryan 10 year Treasury Index. They're not actively managed and generally have lower fees.

Exchange Traded Funds

Exchange Traded Funds (ETF) have characteristics of both mutual funds and shares of stocks.

Bond ETFs are a type of fund designed to track a specific bond index such as the Ryan 10 year Treasury Index. They hold a basket of bonds that mirror the index. So you can expect the return to be very close to the return on a 10-year Treasury bond.

The number of shares is not fixed. There is no maturity date.

They are not actively managed and tend to have expenses less than half that of actively managed bond mutual funds.

Shares trade on the stock exchanges, are priced continuously throughout the day and can be purchased like stocks through any brokerage account at any time during stock market hours. Comparatively, mutual funds must be purchased through the fund sponsor, are priced once a day and are bought and sold at the end of the day.

To buy and sell ETF shares you pay a brokerage commission. Mutual funds may be "front loaded" (charge a fee to buy), "back loaded" (charge a fee to sell) or have the sales charge built into the fund.

Like stocks – and unlike mutual funds - you can trade options on ETFs as well as sell them short.

Share prices are influenced by the same factors that influence bond prices in general, namely:

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Changes in interest rates, changes in the yield curve and changes in the yield spread all driven by economic forces as discussed in “*Bond Market: Risk... What Risk*”

Bond ETFs are a very convenient way to easily and conveniently get in and out of targeted bond positions in any quantity you desire.

Passive versus Active Bond Investing

It's not too difficult to have a “set it and forget it” bond portfolio. The most popular passive strategy is “***laddering***”.

Laddering very simply involves buying different durations of bonds such as 2-year, 5-year, 7-year, 10-year, 20-year.

Why would you do that?

It achieves some diversity. Shorter term maturities are generally less sensitive to interest rate changes. Longer maturities generally offer greater interest rates. So a laddering strategy offers some balance between risk and return.

Active strategies focus on generating value by exploiting aspects of the market.

There are three areas of focus:

- Duration management or Yield curve positioning
- Sector allocation
- Security selection

Duration Management involves:

- Over weighting shorter duration bonds when rates are rising and/or the yield curve is flattening.
This allows you to not get locked into lower rates long term.
- Over weighting longer duration bonds when rates are declining and/or the yield curve is steepening
This allows you to lock in higher rates for a longer period.

Sector allocation involves taking advantage of temporary imbalances between sectors. Active managers are familiar with historical spreads. When a particular sector temporarily declines, it's a good time to “buy low”. When a sector temporarily overshoots its historical trend, it's a good time to “sell high”.

Security allocation involves bond picking... which bonds within the desirable classes offer the best risk/reward profile. An active manager may be able to uncover not obvious intrinsic value in specific bond offers.

While bonds are known as being hum-drum and conservative, as you can see, they are multi-dimensional. Your financial planner can guide you through intelligently choosing a bond strategy and the easiest way to realize your objectives.

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The Ryan Treasury indexes are indexes developed by Ronald J. Ryan, who has calculated and maintained Treasury indexes since 1983. The Ryan Indexes track the performance of the most recently auctioned Treasury securities.

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An investment in ETFs involves risk, including loss of principal. Diversification does not eliminate the risk of experiencing investment losses. By investing in high yield bonds you may be subjected to greater price volatility based on fluctuation in issuer and credit quality.

When investing in bonds, you are subject, but not limited to, the same interest rate, inflation and credit risks associated with the underlying bonds owned by the ETF.

ETFs are subject to trading risks similar to those of stocks including those regarding short-selling and margin account maintenance.

Ameristock ETFs are subject to increased risk associated with investing in a specific sector compared to a more diversified investment.

Income may be subject to state or local taxes and, to a limited extent, certain federal tax. Capital gains are subject to federal, state and local taxes.

Funds distributed by ALPS Distributors, Inc.

An investor should consider the investment objectives, risks, charges and expenses of the ETF carefully before investing. To obtain a prospectus containing this and other information, please call 800-394-5064. Please read the prospectus carefully before investing.