

The Yield and Market Value



"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."

-Warren Buffett

A bond's yield is directly related to not only the fed funds rate, but also its maturity- in a normal market environment, the longer the maturity, the higher the yield.

The Fed Funds rate, which represents the overnight lending rate between banks, is the base rate for most US debt instruments and has fluctuated from 1% to 19% since 1954. Of course, there are maturity and risk premiums that add to the final yield of the instrument, but it is critical to understand the base rate because it will directly affect the market value of one's bond portfolio.

Another fact that should be understood is that while

bonds are considered a "safer" investment than individual equities, they too are traded on a market consisting of buyers and sellers.

If for instance, we buy a bond maturing in five years that pays a 5% coupon and interest rates increase significantly immediately after we purchase our bond, the market value of the bond will decline. The reason of course is that current bond buyers won't want to buy a 5% coupon, when they are now able to buy a new issue that pays 7% (for a similar maturity), thus the market value of the bond goes down.

At the same time, the pricing pressure on existing bonds has the effect of pushing the actual yield-to-maturity up

while the price of the bond goes down.

The pressure created by an upward change in interest rates does not affect the coupon payments, but as the portfolio is "marked to the market", the market value in client accounts declines temporarily and is eventually lifted again by the "maturity pull" (*see below*).

For this reason, investors who use a laddered strategy should be committed to holding each issue to maturity. If market conditions or client objectives change, maturing issues can always be reinvested into another asset class.

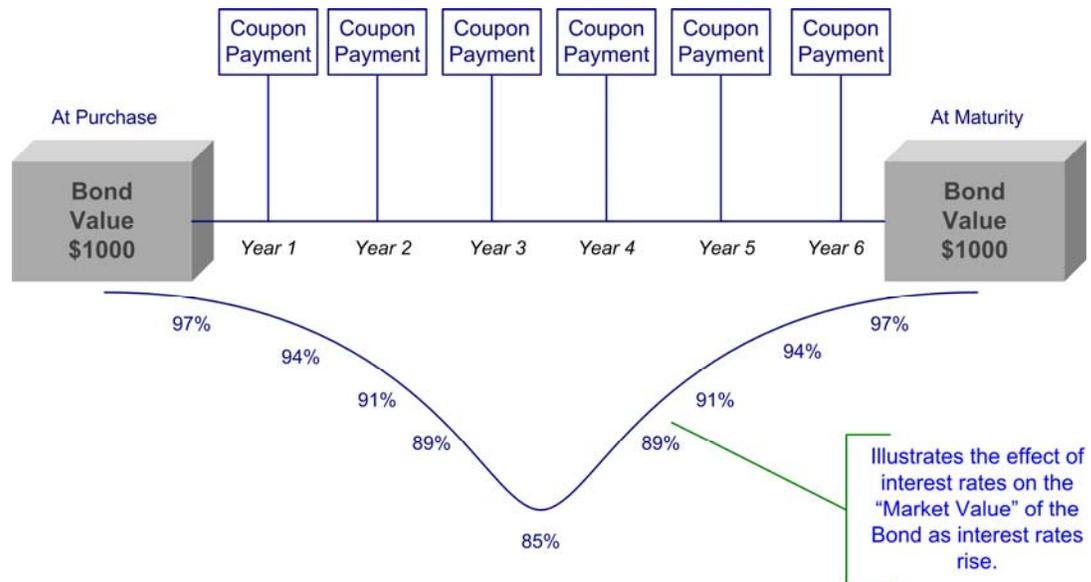


Merritt Capital Mgmt.
36 Maplewood Ave.,
Suite 1
Portsmouth, NH 03801

Contact

Shane E. Merritt
Registered Principal

shane.merritt@wfafinet.com



Note: *In a declining interest rate environment, the portfolio would typically appreciate in market value and begin to decline back to par pricing as each issue matures.*

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Market values of individual bonds change as market conditions change. There is no assurance that this or any strategy will ultimately be successful or profitable nor protect against a loss. Strategies discussed may not be suitable for all investors.

We hope this information has been both helpful and educational. If you would like further information regarding Bond Ladders or more sophisticated investment strategies, please email us at: shane.merritt@wfafinet.com

Further Reading

Bill Gross on Investing, by William H. Gross

Investing in Fixed Income Securities: Understanding the Bond Market, by Gary Strumeyer

Fixed Income Strategy: A Practitioner's Guide to Riding the Curve, by Tamara Henderson

Glossary:

Coupon Rate: The annual interest rate paid to bondholders, expressed as a percentage of par value. A \$1,000 par value bond with a 7% coupon pays \$70 annually, or \$35 every 6 months.

Duration: Duration is a measurement of how long in years it takes for the price of a bond to be repaid by its internal cash flows and also indicates how interest rate changes will affect bond prices. The duration is shorter than the stated term to maturity on all securities except zero coupon bonds, for which they are equal.

Maturity: The date on which the principal amount becomes due and payable to the bondholder.

Par Value: The principal amount of the bond due the holder at maturity. Most bonds trade in denominations of \$1,000 par value.

Price: Bond prices are quoted as a percentage of par value. A \$1,000 bond trading at 90 1/2 is priced at 90.5% of \$1,000, or \$905 per bond.