ADVISER INVESTMENTS

SPECIAL REPORT

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The Benefits of Bonds

There is a popular misconception that bonds are appropriate investments only for the very old or the very wealthy. The truth is that investors of all ages and economic circumstances can benefit from diversifying their investment portfolios with bonds.

As many investors learned during the challenging stock market conditions of late 2008 and early 2009, bonds can cushion your portfolio from stock market volatility and provide a steady stream of income in good times and bad. While bond-focused mutual funds are appropriate for many investors, an actively-managed portfolio of individual bonds can be appropriate for high-income earners, retirees or anyone looking to preserve hard-earned capital and generate a specific rate of return over a defined period of time.

This primer on bond investing is designed to help you better understand the potential rewards of bonds, along with a discussion of the risks.

What exactly is a bond?

Bonds are essentially loans made by investors to corporations, state and federal governments and government agencies.

In return for lending money to the bond's issuer, the bond investor earns a fixed interest rate for a specific term, generally ranging from one to 30 years. Interest is typically paid on a semiannual basis. When the term of the loan expires (known as the bond's maturity date), the bond issuer repays the principal of the original loan (typically the "face value" of the bond you own).

Am I guaranteed to get all of my money back when I invest in bonds?

Historically, investment-grade bonds have had a very low default rate.

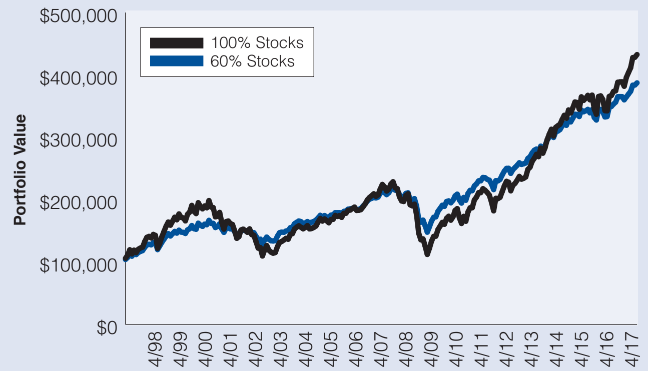
While only U.S. Treasury bonds are backed by the full faith and credit of the Federal government, municipal bonds and high quality corporate bonds also have solid track records of returning investors' principal, plus interest, at maturity.

What are the benefits of investing in municipal bonds?

Due to their tax-exempt status, municipal bonds can deliver attractive tax-free income with low risk.

Municipal bonds are issued by states, cities, towns, municipal agencies and other tax-exempt entities, such as hospitals and universities. Interest earned from these bonds is exempt from federal taxes, as well as state and

Bonds Smooth the Ride



Source: Morningstar Direct

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Consider adding bonds to your portfolio if you are looking to:

- Diversify an equity-dominated portfolio
- Add stability to your portfolio and reduce volatility
- Generate a dependable stream of income
- Preserve capital

local taxes, in many cases. While yields on municipal bonds are typically lower than corporate or U.S. Treasury bonds, when you factor in the impact of federal, state and local taxes, the taxable equivalent yield on municipal bonds may exceed what you can earn from other types of bonds. It is not always about what you earn, but what you keep—and with most munis, you keep it all. Moreover, because they are backed by local governments with the power to tax, municipal bonds have typically had an extremely low default rate. In fact, Moody's Investors Service found that over a 46-year period (1970-2015), there were just 99 defaults out of 18,000 Moody's-rated municipal bonds.

Why do bond yields often seem low when compared to the potential returns from stocks?

Investment-grade bonds are generally less volatile and less risky than stocks. Bond yields, or the return you expect to receive from a bond, reflect their lower risks.

Returns and risks go hand-in-hand. There are years when stocks produce stellar returns and years when they produce stinging losses. For example, in 2008, the return on the S&P 500 Index was -37%, while in 2013 it was +32%. Conversely, investment-grade bonds are generally less volatile. Bonds (as measured by the Bloomberg Barclays U.S. Aggregate Bond Index) gained 5% in 2008 and 2% in 2013.

If stock market volatility keeps you up at night, you may enjoy a smoother ride (and a better night's sleep) by adding bonds to your stock portfolio, or by investing exclusively in bonds.

To illustrate how bonds can reduce volatility, consider Sam, a hypothetical investor with a $500,000 portfolio. If Sam had been invested 100% in stocks during the market crash in 2008, his portfolio would have declined 37% ($185,000), based on the performance of the S&P 500 Index. On the other hand, if Sam had his portfolio split evenly between stocks and bonds (as measured by the Bloomberg Barclays U.S. Aggregate Bond Index) he would have experienced a decline of 16% ($80,000) in 2008.

Moody's and Standard & Poor's Ratings

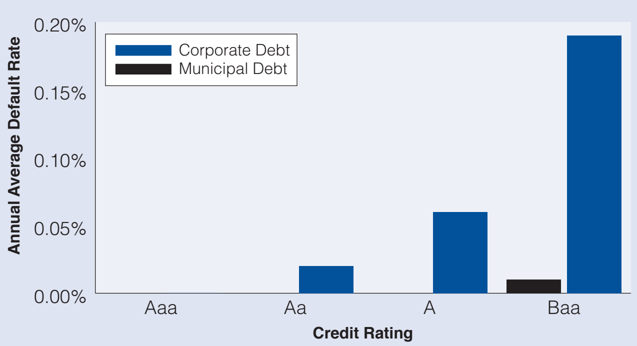
- A long history of accuracy was interrupted by higher ratings assigned to more complex securities.
- Their ratings represent just the first step in reviewing a security's quality.

How do fluctuating interest rates affect bond prices and yields?

Bond prices are inversely related to interest rates. Therefore, when interest rates rise, bond prices fall, and vice versa.

Why does this happen? Let's say you own a 10-year U.S. Treasury bond that pays 5% interest. If interest rates rise, new bonds issued by the Treasury will need to offer higher interest rates to attract investors. Therefore, the Treasury may start issuing new 10-year bonds that pay 6% interest. When this happens, bonds that pay 5% interest will be less attractive to prospective buyers and will be valued less than bonds that pay 6% interest. Conversely, if interest rates are falling and the government issues new bonds with a 4% coupon rate, bonds that pay 5% interest will be more highly valued and will trade at a premium. Investors who plan to hold their bonds until maturity can ignore fluctuating interest rates as their yields are fixed until the bond matures.

Average Annual Default Rate by Credit Rating Investment Grade Debt, 1970-2015



Source: Moody's

Bond Credit Ratings

	Moody's	Standard & Poor's
INVESTMENT GRADE	Aaa	AAA
	Aa1	AA+
	Aa2	AA
	Aa3	AA-
	A1	A+
	A2	A
	A3	A-
	Baa1	BBB+
	Baa2	BBB
	Baa3	BBB-
BELOW INVESTMENT GRADE	Ba1	BB+
	Ba2	BB
	Ba3	BB-
	B1	B+
	B2	B
	B3	B-
	Caa1	CCC+
	Caa2	CCC
	Caa3	CCC-
	Ca	CC
	C	C
	D	D
	NR	NR

Source: Moody's and Standard & Poor's

Given the risk of fluctuating interest rates, would I be better off keeping my money in cash, short-term CDs, or money market funds?

Cash, CDs and money market funds are appropriate for short-term cash flow needs.

The safety of cash and money market accounts is offset by their low yields. Keeping too much of your savings in low-yielding cash accounts, CDs or money market funds may not provide the returns you need to outpace inflation. While bonds are subject to credit and interest rate risk, careful research can help mitigate these risks.

How can I determine the credit-worthiness of individual bonds?

Generally, bonds are either rated "investment-grade," or "below investment-grade," and there are gradations within each category. The higher a bond's credit rating (determined by an independent rating company), the lower the risk that the issuer will be unable to pay interest or repay principal at maturity.

The highest quality bonds are rated AAA by Standard & Poor's and Aaa by Moody's Investor Services. Bonds that have a higher risk of defaulting on principal or interest are rated lower. Lower-quality bonds pay higher interest rates to compensate for higher risk. Investors who are seeking steady income with low risk should stick with high-quality investment-grade bonds.

Who are these independent bond-rating companies?

Credit-rating companies such as Standard & Poor's and Moody's Investors Service perform due diligence on bond issuers to assess their ability to pay interest and repay principal.

Historically, these firms have provided accurate and consistent ratings, with one glaring exception. During the housing market boom of the early- to mid-2000s, some of the credit raters gave AAA ratings to securitized pools of mortgages and other derivative products that, in retrospect, were not warranted. This was a blemish on what has otherwise been a consistent track record of assessing bond risk. Because the credit-rating companies are not infallible, it's important for portfolio managers to use assigned ratings as a first step in a more detailed due diligence on a bond issuer before investing clients' capital.

Why would I buy bonds rather than bond funds?

Individual bonds are better suited for investors who are looking for capital preservation and income. Bond funds are a better vehicle for investors more concerned about earning a competitive total return on their investment.

When you invest in an individual bond, the issuer is obligated to pay a specific amount of interest over a specific period of time. When the bond matures, you receive your investment principal back. Your income from a bond is fixed when you buy it—so you know what you're getting for as long as you own the bond.

Alternatively, a bond fund's interest payments will fluctuate with interest rates. In a period when interest rates are falling, a bond fund's monthly payments may decline as well. In a rising rate environment, the inverse is possible.

While bond funds offer more diversification than individual bonds, there is no promise to repay your principal at maturity and your shares may be worth more or less that what you paid for them when you sell them. Choosing between individual bonds and bond funds depends on your individual goals, time horizon and risk tolerance.

The Adviser Investments Managed Bond Program

Our Managed Bond Program is designed for investors who prefer to invest in high-quality individual bonds, rather than bond funds. This program provides a steady stream of income while protecting your investment principal.

Constructing a well-diversified bond portfolio is both an art and a science. Our fixed-income research team has the experience, knowledge and perspective to build a diversified portfolio of high-quality bonds to meet your individual needs. While we cannot control the markets or make any guarantees (we're fortune builders, not fortune-tellers), we manage the level of risk in your bond portfolio carefully to protect your wealth.

To learn more about bonds or the Adviser Investments Managed Bond Program call (800) 492-6868.