

Tax-Free Laddered Approach

One of the simplest and most effective ways of structuring a bond portfolio is to take the laddered approach. A laddered bond portfolio is comprised of individual bonds with maturities occurring at regular intervals over a given period of time. Consider the following example of a ten-year tax-free municipal bond portfolio with a par value of \$250,000:

Par Value	Rating (Moody/S&P)	Description	Coupon	Maturity	Cur Mkt Price	YTM	Cur Yield	Duration
\$50,000	AAA/AAA	HOUSTON TEX UTIL SYS REV	3.50%	5/15/2008	\$100.00	3.50%	3.50%	1.88
\$50,000	AAA/N/R	RICHLAND CNTY S C SCH DIST NO 002	3.60%	3/1/2010	\$100.00	3.60%	3.60%	2.55
\$50,000	AAA/AAA	LITTLE ROCK ARK	3.75%	4/1/2012	\$100.00	3.75%	3.75%	3.23
\$50,000	AAA/AAA	SOUTHERN CALIF PUB PWR AUTH TRANS PROJ REV	3.85%	7/1/2014	\$100.00	3.85%	3.85%	4.83
\$50,000	AAA/AAA	CONNECTICUT ST	4.00%	6/1/2016	\$100.00	4.00%	4.00%	6.14
Average:			3.74%		\$100.00	3.74%	3.74%	5.12
\$250,000								

A laddered portfolio takes advantage of the yield curve. In this example the yield curve has a positive slope, which is usually the case. This means that as maturities lengthen, the yield of the issues increases. A laddered portfolio helps smooth out the bumps of interest rate cycles. In a rising interest rate environment most bond investors want to hold short maturities since bond values fall as rates rise – and the longer the maturity, the larger the decline in value. Conversely, if interest rates fall, longer maturities are desirable. A laddered portfolio is effectively a solid middle ground and provides a cushion during times of rising interest rates.

The concept of a laddered portfolio is simple: as the shorter bonds mature, the proceeds are reinvested in the next longest maturity. In the example above, in May of 2008, the \$50,000 from the maturing Houston Texas Utility bonds should be invested in a bond with a maturity of 2018. Once the ladder is established, each new investment is in a longer, usually higher yielding maturity. The investor is now creating “rungs” on the ladder.

There are many variations to the ladder theme. The example above is of a ten-year ladder with two-year intervals. A longer ladder, such as a twenty-year ladder or thirty-year ladder, will typically generate a higher yield but it will also have more principal volatility. The total value would tend to fall more in a rising interest rate environment when compared to a ten-year ladder. **Duration** is the metric used by professional portfolio managers to assess a security or portfolio’s vulnerability to interest rate changes. For example, the duration of the above ladder is 5.12 years. The duration of a bond or portfolio will change as interest rates change.

Going in the other direction a five-year ladder would offer a lower overall yield but would be less volatile. Ladders can also be created with Certificates of Deposit, corporate bonds, U.S. Treasuries and other fixed income securities.

Key points to consider include:

- This is not a strategy for maximizing yield. To get maximum yield you need to invest exclusively in the longest maturities and assume the risk (and potential reward) of more volatility.
- This is not a strategy to minimize risk of erosion of principal. To absolutely protect your principal you need to buy very short-term Treasury bills with the commensurate low yields.
- Pay attention to redemption features. A high coupon, twenty-year maturity bond with a five-year call is likely to be redeemed in five years and not last until the twenty-year maturity.
- Although this strategy offers maturity diversification, it is not a substitute for credit diversification. If you own a non-investment grade bond of a company that goes bankrupt your bond may never mature.

Duration:
The weighted maturity of a fixed-income investment’s cash flows; used in the estimation of the price sensitivity of fixed-income securities for a given change in interest rates.

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