

## Taxable Laddered Approach

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

CUSIP	Par Value	Rating (Moody/S&P)	Description	Coupon	Maturity	Cur Mkt		Cur	
						Price	YTM	Yield	Duration
302570AQ9	\$50,000	A2/A-	FPL GROUP CAP INC GTD DEB	3.250%	4/11/2006	\$100.56	2.94%	3.23%	1.80
742718BX6	\$50,000	Aa3/AA-	PROCTER & GAMBLE CO SR NT	4.300%	8/15/2008	\$101.15	4.00%	4.25%	3.83
39607PCT4	\$50,000	NR/NR	GREENVILLE FIRST BK SC CD	4.500%	5/28/2010	\$99.06	4.68%	4.54%	5.26
3134A4QD9	\$50,000	Aaa/AAA	FEDERAL HOME LN MTG CORP	5.125%	7/15/2012	\$100.28	5.08%	5.11%	6.63
25468PCA2	\$50,000	Baa1/BBB	DISNEY WALT CO MTNS BE FR	6.200%	6/20/2014	\$102.99	5.80%	6.02%	7.42
<u>\$250,000</u>		Average:		<u>4.675%</u>		<u>\$100.81</u>	<u>4.50%</u>	<u>4.63%</u>	<u>4.99</u>

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 issue 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 April of 2006, the \$50,000 from the maturing FPL Group bonds should be invested in a bond with a maturity of 2016. 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 a ten-year taxable ladder with two-year intervals. The investments include corporate bonds, an agency, and a certificate of deposit. 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 4.99 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 municipal 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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