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High-Yield Bonds: The Pros and Cons

Interest rates at historically low levels are great for those looking to refinance a mortgage or borrow money to start a business. However, people who rely on their investments for income have sought out a variety of alternatives to rock-bottom yields on U.S. Treasuries, including high-yield bonds. If you're considering investing in high-yield bonds--sometimes called "junk bonds"--yield shouldn't be the only factor in your decision.

What are high-yield bonds?

High-yield bonds are corporate bonds considered less than investment grade (a rating of BB or lower from Standard & Poor's or Fitch, Ba or lower from Moody's). A bond can fail to achieve investment-grade status for many reasons. A company may be in a turnaround situation; high-yield bonds have frequently been used as a way to finance large-scale leveraged buyouts, such as that of RJR Nabisco in the 1980s. Or the company might already have substantial debt on the books, or have a risky or untested business model. Whatever the reason, there is greater uncertainty about the company's ability to repay its debt.

The advantages

So why would an investor be willing to face those risks? In a word, yield. The more uncertainty about an issuer's ability to repay its debt, the higher the interest rate investors typically demand from its bonds. As of early November 2012, one benchmark index of high-yield bonds was yielding almost 4% more than a comparable index of corporate bonds, and almost 5% more than a 10-year Treasury.*

Because a junk bond's yield is often more dependent on the quality of the issuer than on other factors, it can sometimes be less affected by interest rate changes than investment-grade yields. That difference can provide an additional level of diversification for a bond portfolio (though diversification alone cannot guarantee a profit or protect against potential loss). You can provide still another level of diversification by investing in a variety of high-yield bonds from different issuers in different industries.

Don't forget that even high-yield bonds typically have precedence over common stocks in the event of a bankruptcy; that increases the odds that you would receive at least part of your original investment if the issuer went under.

Factors to consider

Not surprisingly, default rates on high-yield bonds tend to be lower when the economy is robust; renewed recession could mean more defaults by companies already on shaky ground. Also, remember that selling any bond before it matures could mean a loss of principal. While interest rates are expected to remain low for another couple of years, bond values generally are likely to fall when rates begin to rise. A credit rating downgrade of your high-yield bond also would likely reduce its market value. Finally, recent investor interest has boosted prices of high-yield bonds generally; consider getting expert help in deciding whether high-yield, investment-grade debt, or dividend-paying equities represent a better investment at current valuations.

If you're a long-term investor, there's another factor to consider. Bonds can have a call provision that lets the issuer redeem the bond before it matures. The lower current interest rates are, the more likely they are to trigger call provisions on bonds with a higher rate. If you rely on the interest from a high-yield bond and it gets called, you'll be faced with the challenge of replacing that income.

Also, individual high-yield bonds can sometimes be less liquid than investment-grade bonds, so you might have some difficulty selling the bond at your asking price. And during periods of global uncertainty, high-yield bond values can drop as investors flock to less risky investments generally. As with any investment, make sure you're being compensated for the level of risk you're willing to take.

*Data based on yields reported for Merrill Lynch High Yield Constrained Index, Barclays Capital U.S. Corporate Bond Index, and daily Treasury yield curve rates as of November 7, 2012.

See disclaimer on final page

Compounding Can Add Fuel to Your Portfolio

Note: The examples in this article are hypothetical and for illustrative purposes only. They assume a steady 6% annual rate of return, which does not represent the return on any actual investment and cannot be guaranteed. Moreover, the examples do not take into account fees and taxes, which would have lowered the final results. Speak with a financial professional about how these examples might relate to your own investing circumstances.

If you enter the terms "Albert Einstein" and "compounding" into an Internet search engine, you'll discover a wide variety of quotes attributed to the great inventor. Some results say Einstein called compounding the "greatest mathematical discovery of all time," while others say he called it the "most powerful force in the universe." Despite the many variations, Einstein's point is valid: compounding can add fuel to your portfolio's growth. The key is to allow enough time to let it go to work.

Time and money can work together

The premise behind compounding is fairly simple. If an investment's earnings are reinvested back into a portfolio, those earnings may themselves earn returns. Then those returns earn returns, and so on. For instance, say you invest $1,000 and earn a return of 6%--or $60--in one year. If you reinvest, combining that $60 with your $1,000 principal, and earn the same 6% the following year, your earnings in year two would increase to $63.60. Over time, compounding can snowball and really add up.

Say at age 45 you begin investing $3,000 annually in an account that earns 6% per year, with earnings reinvested. At age 65, your $60,000 principal investment would be worth almost twice as much--about $117,000. That's not bad, right?

Now consider what happens if you begin investing at age 35, using the same assumptions. By 65, your $90,000 principal would nearly triple to just over $250,000.

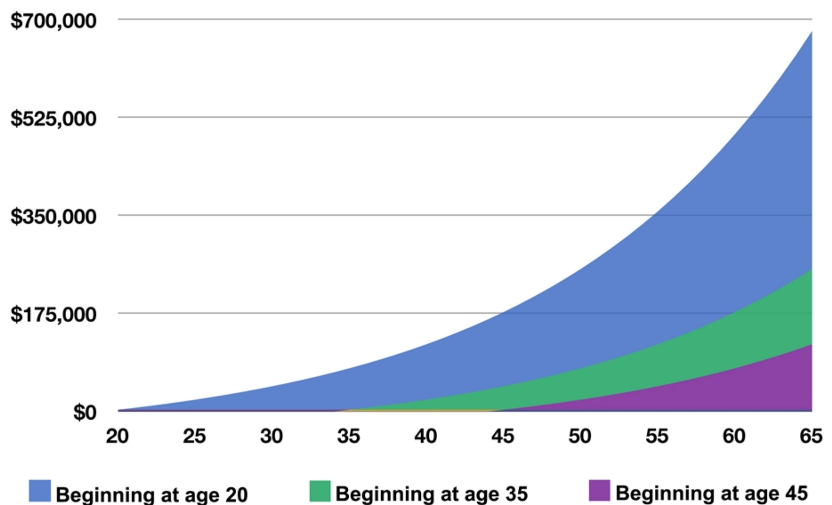
Finally, consider the results if you start at age 20: your $135,000 investment would be worth a jaw-dropping five times as much--$676,524. That's the power of compounding at work.

But how long do I have to wait?

If you'd like to estimate how long it might take for your investment to double, you can use a principle known in investment circles as the "Rule of 72." To use the rule, simply divide 72 by the expected rate of return. For example, if you expect to earn an average of 8% over time, the Rule of 72 gauges that your investment would double in approximately nine years. (This rule applies to lump-sum investments, not periodic investment plans such as those given as examples in this article.)

With compounding, the more patience you have, the better off you may be over the long term. The examples in this article assume a steady 6% rate of return each year; however, in reality, no investment return can be guaranteed. Your actual earnings will rise and fall with the changing economic and market conditions. That's why it's so important to stay focused on the long term. Over time, the ups and downs may average out, and your earnings can potentially go to work for you.

Perhaps that's why Einstein called compounding "man's greatest invention." Or was it the "eighth wonder of the world"? Regardless ... you get the idea. When it comes to investing, time can be the power behind your potential success.



Real-life Financial Tips for Different Generations

Do you remember The Game of Life®? In Milton Bradley's popular board game, players progress through life stages making decisions that affect their prosperity. Like those players, today's generations face financial decisions with lasting effects. Here are some tips for staying focused despite life's ups and downs.

Generation Z (teens to early 20s):

Accustomed to instant gratification, the "Digital Generation" may need to recognize that financial success takes diligence and patience. Consider sharing the following advice with the Gen Zers in your life:

Live within your means. Your first paycheck provides the chance to learn valuable lessons, such as creating a budget and spending less than you earn.

Build a saving habit. You have one powerful advantage over other generations--time. Why not make saving automatic and direct a part of your paycheck into a savings or investment account?

Understand credit and credit reports. A good credit history helps you get a car loan and a mortgage, but a bad one can ruin your borrowing chances for years. Reviewing your credit report regularly can help you manage your finances and protect your identity.

Generation Y (20s and early 30s):

In this group, you could be juggling your first "real" job, college loans, marriage, a first home, and young children. Three points for you:

Risk management isn't just for companies. Save 6 to 12 months' worth of living expenses in a savings account for unexpected emergencies. Review your insurance, and at a minimum, have health and property coverage. Also consider disability insurance, which helps pay the bills during a health crisis.

Start saving for retirement ... Like Generation Z, time is your strongest ally. Participate in a retirement savings plan at work, if offered, and if your employer offers a match (free money!), contribute enough to get all of it. If you don't have a plan at work, open an individual retirement account (IRA) and invest what you can (up to annual limits).

... And your children's college. In 18 years, a four-year degree could cost as much as several hundred thousand dollars. Give your children a head start by saving now.

Generation X (30s and 40s):

Home ownership, older children, a career in full swing--if you're in this group, your finances may take a back seat to life's daily demands. To help stay focused, consider the following:

Retirement savings trump college savings. Don't risk your future to pay for your children's entire education. There's no financial aid office in retirement.

Don't neglect your health. Are you experiencing new aches and pains? At this age, medical issues can begin to surface, demanding time, energy, and financial resources. Take care of yourself, and before an emergency arises, review your health and disability coverage.

Create a will, if you don't already have one. This important document can help ensure your children are cared for and your assets are distributed according to your wishes. Medical directives should also be established now.

Baby boomers (50s and 60s):

If you're in this age group, you may have both adult children and elderly parents who need assistance, as well as an impending or current retirement. Pointers for you include:

Shift your retirement savings into high gear. People over 50 benefit from higher savings limits on 401(k)s and IRAs. Strive for the maximum.

Visit a financial professional. When should you tap Social Security and your retirement savings? How should you invest your assets to potentially provide a lifetime of income? A financial professional can be a critical coach at this time of your life.

Investigate long-term care insurance. These policies help protect your family's assets from the potentially devastating effects of long-term care. The older you get, the more expensive these policies can be.

Retirees:

The Game of Life ends when players reach retirement, but not so in real life--you still have years ahead of you. Consider the following:

Review the basics. Whether you plan to travel to exotic locales or play board games with your grandchildren, a key to happiness is living within your means. Develop a realistic budget and don't exceed your spending limits.

Manage your income stream. A financial professional can help you choose vehicles and determine an investment strategy to help ensure you don't outlive your assets.

Plan for your family's well-being. A properly crafted estate plan can help you ensure that your wishes are carried out--for both your and your family's peace of mind.

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Is winter storm damage covered by my homeowners insurance policy?

Whether or not winter storm damage is covered by your homeowners insurance policy will depend on the type of policy you have and the type of damage that occurs.

Most standard homeowners insurance policies provide coverage for winter-related storm damage that occurs as a result of wind, snow, ice, freezing rain, and severe temperatures. You'll want to review your homeowners policy to find out which wintertime perils are specifically covered.

It is important to note that standard homeowners insurance policies do not provide coverage for flood damage. So if your home has suffered damage from winter-related flooding (e.g., a heavy snow melt), you generally won't be covered unless you have a separate flood insurance policy in place.

Finally, if your home suffers damage while you leave it unattended during the winter, you'll have some additional issues to consider. For example, certain homeowners policies have exclusions for damages that result from a home not being properly winterized (e.g., not shutting off the water and draining the pipes) or a home being left unoccupied for a long period of time (e.g., more than 30 days).

While your insurance may provide some coverage for winter storm damage, the best option is to take steps to prevent winter-related damage from occurring in the first place. The following are some tips to help protect your home from harsh winter weather:

- Clean your gutters and downspouts so that melting snow can flow freely away from your home
- Inspect and repair roof shingles and flashing to prevent water damage
- Trim tree branches on your property
- Apply weather stripping and caulking around doors and windows and inspect storm doors and windows for broken glass
- Drain water from pipes leading to exterior faucets and remove garden hoses
- Insulate pipes that are susceptible to freezing
- Have your heating system cleaned and inspected

I just installed a new furnace in my home. Is the energy tax credit still available?

Thanks to the American Taxpayer Relief Act of 2012, the tax credit for residential energy property expenditures, such as installing a new furnace, is now available through 2013.

Originally provided for under the Energy Tax Incentives Act of 2005, the residential energy credit expired at the end of 2011, but has been retroactively reinstated and extended to include energy improvements placed in service in 2012 and 2013. The Act provides for a tax credit of up to $150 for the installation of a natural gas, propane, or oil furnace. There is a $500 lifetime limit for the credit--meaning that you won't be able to claim the credit if you claimed the maximum credit in a prior tax year. Visit www.irs.gov and see IRS Form 5695, Residential Energy Credits, for more information.

In addition to the tax credit, you may also be able to save money on the installation of your furnace with a rebate offered by your utility company or your state or local municipality. Rebates can often provide incentives of up to a few hundred dollars per installation. When applying for an energy rebate, consider the following:

- Energy rebates usually require the product to be ENERGY STAR certified
- The amount of the rebate may hinge on the energy efficiency of the product (e.g., a furnace that has a higher efficiency will be eligible for a larger rebate)
- The rebate may only be available for products that have been installed by a certified contractor
- You may have to apply for the rebate within a certain time period after the installation of your energy-saving product

You can visit www.energy.gov for more information.

Finally, keep in mind that installing a more energy-efficient furnace can save you money on your heating expenses over the long run. According to the U.S. Department of Energy, installing a higher-efficiency heating system along with making energy-efficient upgrades can often result in cutting your winter home heating costs in half.

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