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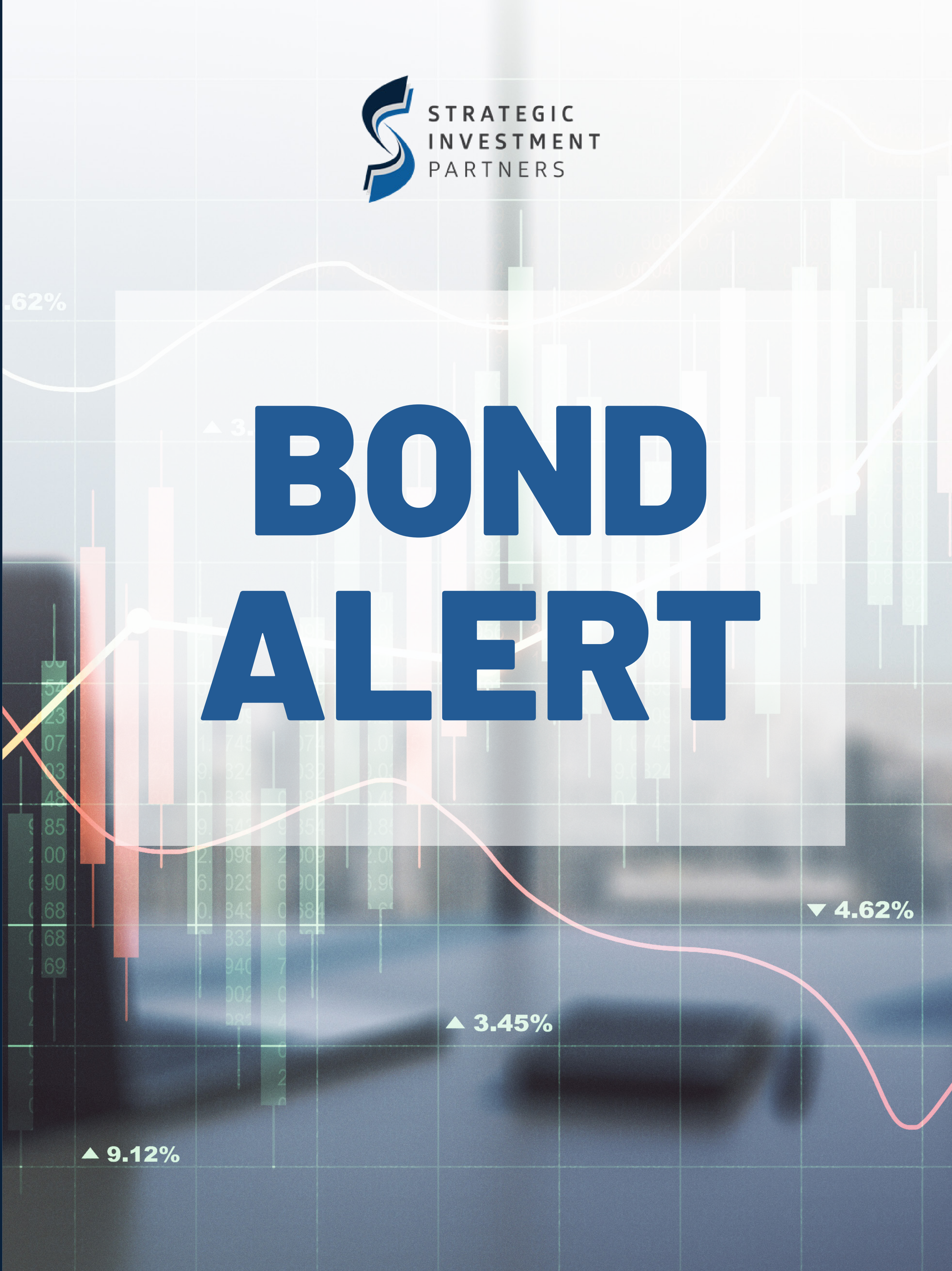
BOND ALERT



Understanding Bonds

WHAT INVESTORS SHOULD KNOW

INTRODUCTION

Bonds are generally popular with investors who are seeking income and want a well-rounded portfolio as part of a long-term financial strategy. Because bond prices move inversely with interest rates, the low interest rates of the last 40 years have kept bond prices at high levels, creating a bull market for bonds issued with higher stated interest rates. However, with recent interest-rate hikes, bond values are now plummeting. In this challenging environment, it's more important than ever that bond investors understand the risks and rewards involved with bonds. That way they can make informed decisions as they map out their investment strategy.

BOND BASICS

Bonds are essentially loans that investors make to the bond issuer, which can be a corporation, government, federal agency or other organization. As a result, bonds are frequently referred to as debt securities since they are a debt the issuer owes to its bondholders. Since investors won't lend their money without compensation, bond issuers promise bondholders interest as well as repayment of the original sum (the bond principal). Bonds are also known as fixed-income securities because many pay out interest at a rate and interval set when the bond is issued.

Investors may be attracted to bonds for several reasons:

- **Income generation —** Most bonds pay interest to their bondholders, normally annually or semiannually.
- **Potential for capital appreciation —** Positive events such as improvements in the credit quality of the issuer or declining interest rates can reward investors with increases in bond market value.
- **Security —** If a company is liquidated, bondholders usually have priority over stockholders and are more likely to receive repayment.
- **Risk diversification —** Bonds can help investors spread assets across different segments of the financial market, reducing their concentration in any single asset class. *Note: Diversification cannot eliminate risk or protect principal during periods of widespread market declines.*

Like all investments, bonds offer a balance between risk and potential return. The risk that concerns most investors is the chance that they will lose some or all of the money they invest; the return is the money investors stand to make on the investment. The balance between risk and return varies based on the investment, the entity that issues the security, the state of the economy, large market movements, and many other factors. In general, to earn higher returns, an investor must take greater risks.

Bonds are generally considered to be less risky than stocks for a few reasons:

- Bonds carry an explicit promise to return the face value (principal) of the security to the investor at maturity.
- Most bonds promise to pay out a fixed rate of interest income to the investor. Some stocks pay dividends, but there is no explicit promise to do so.
- Historically, the bond market has been less vulnerable to price swings and volatility than the stock market.

UNDERSTANDING BOND RISKS

Despite their less-risky characteristics, bonds still come with certain general and specific risks. While not exhaustive, here are the more prominent risks you should be aware of when investing in bonds:

Reinvestment risk: The possibility that an investor will not be able to reinvest cash flows from an investment — like a bond's interest payment — at a rate comparable to their current rate of return. Reinvestment risk typically increases when interest rates are projected to decline.

Inflation risk: Inflation causes future dollars to be worth less than today's. Since a bond's principal does not grow over time, investors risk a reduction in the purchasing power of future interest income and principal over time.

Market risk: This is the risk that the bond market will decline as a whole, bringing down the value of individual bonds, regardless of their fundamental characteristics.

Call risk: Some bonds contain a "call provision," which allows their issuers to redeem them prior to maturity, causing an investor's principal to be returned sooner than expected and making them lose out on future interest payments. Declining interest rates may trigger the redemption of a callable bond, forcing investors to reinvest the principal at lower interest rates.

Interest rate risk: The potential for losses that result from changes in interest rates. Generally, when interest rates rise, bond prices fall. Conversely, when interest rates decline, bond prices typically rise.

Duration risk: The sensitivity of a bond's price to changes in prevailing interest rates. The higher a bond's duration, the more sensitive its price to interest rate changes.

Interest rate risk and duration risk have taken on greater import in today's environment of rising interest rates.

COMMON QUESTIONS ABOUT BOND DURATION

What is bond duration?
Duration is a number that measures a bond price's sensitivity to interest rates. The higher a bond's duration, the more sensitive a bond's price is to interest rate changes.

How can I find the duration of an individual bond?
A number of factors can affect a bond's duration. The simplest way to find this information is to ask your investment professional or the bond's issuer. You can also consult an online bond duration calculator.

Does low duration mean low risk?
No. Just because a bond's duration is low, it does not mean your investment is riskfree. In addition to duration risk, bonds are subject to inflation risk, call risk, default risk and other risk factors.

What affects a bond's duration?
Variables such as how much interest a bond pays during its lifespan, the bond's call or redemption features, yield, credit quality of the issuer, maturity, all play a role in duration computations.

Financial, Business, Retirement, and Estate Planning

THE RELATIONSHIP BETWEEN BOND VALUES AND INTEREST RATES

Generally speaking, bond prices and interest rates have an inverse relationship, meaning that when interest rates rise, bond prices fall because new bonds are issued paying higher "coupon" or interest rates, making the older, lower-coupon bonds less attractive to investors. When interest rates decline, bond prices rise because the higher interest payments of the older bonds are more attractive than the new lower-paying bonds.

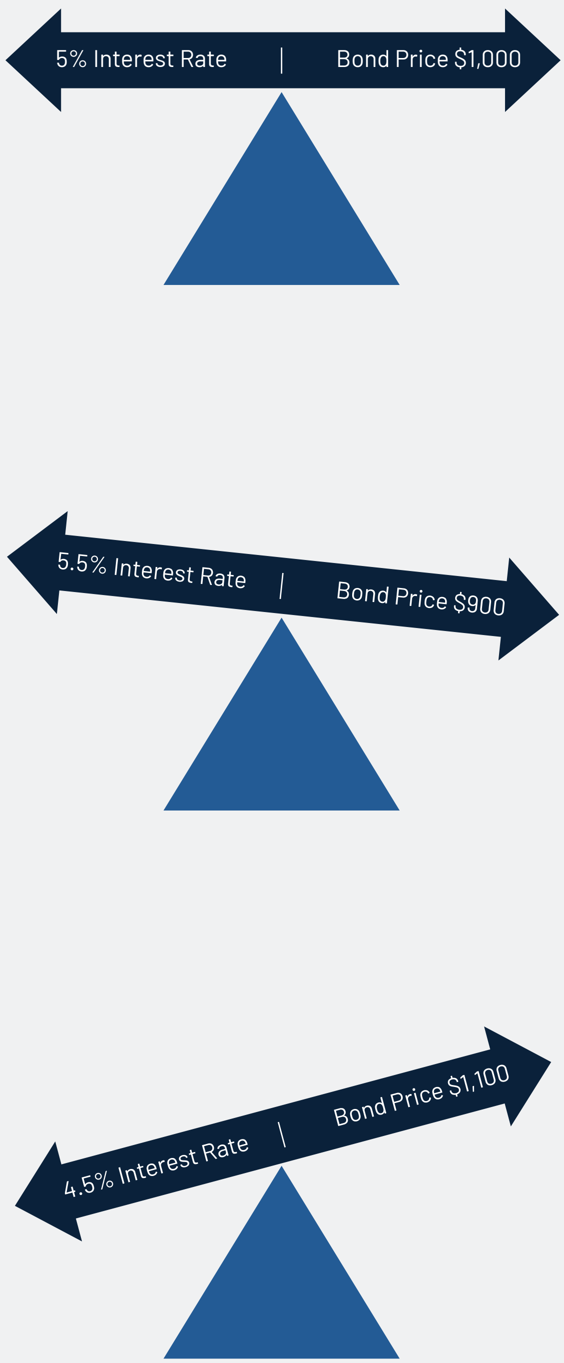
Typically, the longer the term of the bond, the greater the price fluctuation or volatility that occurs from a change in interest rates. Duration risk is the risk associated with the sensitivity of a bond's price to a one percent change in interest rates. The higher a bond's duration, the greater its sensitivity to changes in interest rates and the greater the fluctuations in market price the bond may experience. If you sell a bond before maturity, the price you will receive (regardless of the face value of the bond) will be affected by the prevailing interest rates and the bond's duration, as well as other fundamental factors of the bond.

When interest rates rise, outstanding bonds, particularly those paying a low coupon rate and with high duration, may experience significant drops in market value. For example, if interest rates were to rise by two percent, a medium investment grade corporate bond (BBB, Baa rated or similar) with a duration of 8.4 (10-year maturity, 3.5 percent coupon) could lose 15 percent of its market value.

A similar investment grade bond with a duration of 14.5 (30-year maturity, 4.5 percent coupon) might experience a loss in value of 26 percent. The higher level of loss for the longer-term bond happens because its duration number is higher, making it more sensitive to interest rate changes.

It's important to remember that these price fluctuations only matter if you intend to sell a bond before maturity. Bonds will pay out the same face value at maturity regardless of their market value, unless the issuer goes bankrupt or otherwise fails to pay back the principal.

PRICE MOVEMENTS OF A HYPOTHETICAL BOND



INTEREST RATES AND THE FEDERAL RESERVE

The purpose of the Federal Reserve is to maintain a stable and growing economy by keeping prices stable and unemployment to a minimum.

To achieve these ends, the Fed uses the following tools:

- **Manipulates short-term interest rates:** Raising or lowering interest rates to slow or spur economic activity and control inflation.
- **Engages in Open Market Operations (OMO):** Buying or selling Treasury bonds and other debt-based securities in the open market. Buying bonds increases the money supply and lowers interest rates; selling bonds does the reverse.
- **Adjusts bank reserve requirements:** How much a bank must hold in reserve compared to how much it can lend out. Lowering reserve requirements increases the money supply; raising requirements contracts the supply.

In order to boost economic activity after the financial crisis of 2007-2008, the Fed lowered the federal funds rate to nearly zero and embarked on a series of "quantitative easing" programs, purchasing billions in Treasury and Mortgage-backed securities. The net effect was an increase in demand for these bonds, pushing bond prices up, interest rates down, and boosting economic activity.

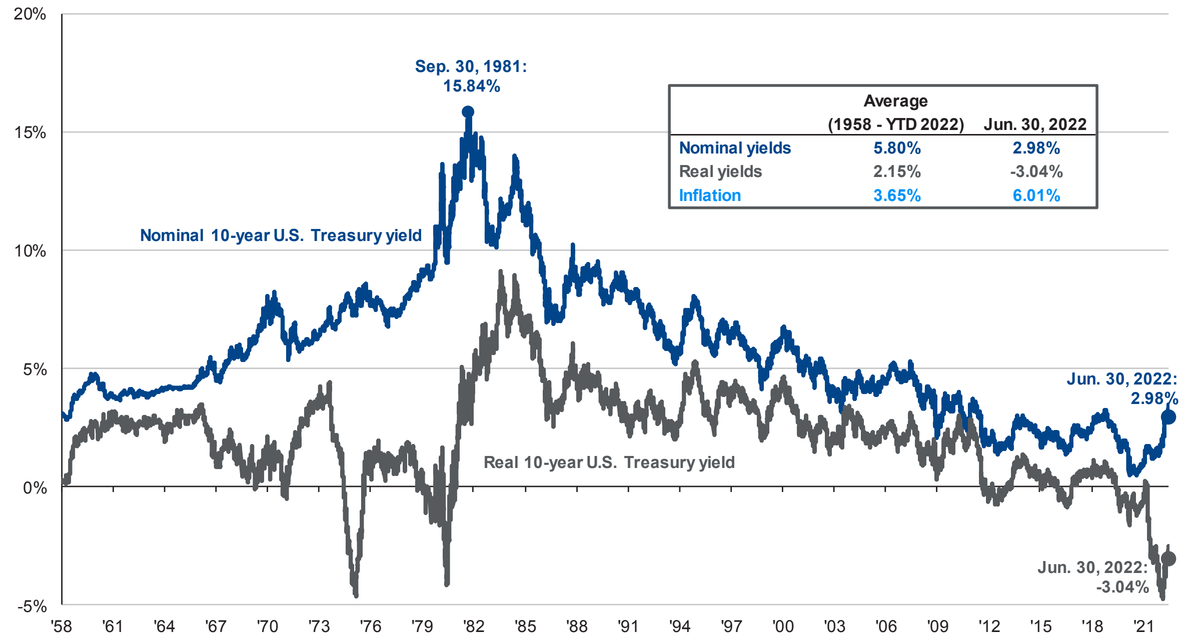
During the recent pandemic and lockdowns, the Fed doubled-down on its "easy money" policy. It kept interest rates and bank reserve requirements extremely low and accumulated trillions of dollars in bonds to increase the money supply and encourage lending and investment.

The strategy worked in spurring the economy: Gross Domestic Product grew at an annualized rate of 5.7% in 2021, the fastest rate since 1984. **But inflation also accelerated to new record heights.**

Now, curbing inflation has become a priority. No surprise, then, that the Fed has reversed course on its easy money policy. Recent moves include raising short-term interest rates and implementing a plan to **reduce its balance sheet of nearly $9 trillion in bond holdings**, mostly Treasury and mortgage-backed securities. *(Board of Governors of the Federal Reserve System, "Total Assets of the Federal Reserve, July 30, 2007 to April 27, 2022." Total assets equal $8.938 trillion.)*

The effect on the bond market has been a decrease in bond values. If the Fed continues to raise interest rates, bond prices will likely plummet even further.

Nominal and real U.S. 10-year Treasury yields



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month. For the current month, we use the prior month's core CPI figures until the latest data is available.
Guide to the Markets – U.S. Data are as of June 30, 2022.

STRATEGIES TO HELP MITIGATE RISK

It's not possible to completely eliminate investment risks, however, there are strategies we can employ to help reduce the impact of certain risks. While future increases in interest rates pose definite risks to bond investors, the correct solution may not be to abandon the bond market; rather, investors should seek out solutions that help them prepare their portfolios for rising interest rates. Indeed, rising rates can be positive for investors since they may increase the availability of high quality, highyield bonds.

One of the strongest tools in our arsenal is a personalized investment strategy that is never on autopilot. At any given time, there are many variables that can affect the value of your portfolio and we are constantly working to balance return against risk. Some of the strategies we employ include:

"Laddering" bonds, a strategy in which investors buy bonds with different, evenly spaced maturities can help reduce the effect of rising interest rates on your overall bond portfolio.

Reducing maturities through selling longer duration bonds and buying shorter duration debt securities can have the effect of reducing duration and reducing your portfolio's sensitivity to interest rate changes.

Holding international bonds from countries where interest rates are higher than in the U.S. can increase bond yields and help reduce durations. However, if considering this strategy, you must be mindful that international investing presents its own unique risks, such as currency fluctuations, political risks, and differences in accounting procedures.

Buying inflation-adjusted securities such as Treasury Investment Protected Securities (TIPS), whose payouts are adjusted according to the rate of inflation can help to reduce duration. This assumes that the rate of inflation rises in concurrence with an increase in interest rates, thus triggering an increase in the payout rate of the bond.

Investors can also look beyond the bond market for opportunities to earn higher rates of return.

Holding dividend-paying stocks can offer an income stream that may increase over time as companies increase dividend payments. Stocks offer growth potential over time that can help fight the effects of inflation. These advantages should be balanced against the potentially higher volatility of equity investments.

Pursuing alternative investment strategies that may have the ability to hedge against rising interest rates or earn a higher return in a rising rate environment. If you have questions about these strategies, please contact us.

CONCLUSIONS & NEXT STEPS

We hope that you've found this special report informative, educational, and reassuring. We feel that it is important to educate our clients about the potential risks and benefits of bond investing. Yes, rising interest rates pose real challenges to bond investing. But they also create opportunities. We will continue to monitor markets and seek out the best ways to leverage those opportunities.

As financial guides for our clients, we work hard to achieve results while charting a course through shifting economic conditions. We also want to offer ourselves as a resource to you, your family, and your friends. We are happy to answer questions about your current financial situation and future goals, and we offer complimentary consultations at any time. Should you have any questions about bond investing or market movements, please reach out. We would be delighted to be of service.

If you have questions or concerns about your portfolio, we are always at your service. It is a pleasure serving you and we are honored by your trust. As always, feel free to contact us at 763-231-6010 with any questions.

Warm Regards,

Al Luttman & Mike Braddy,
SIP Wealth Management
"Money Matters with Al & Mike"

FOOTNOTES, DISCLOSURES, AND SOURCES:

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