Bond Ladders May Hedge Interest Rate Hikes

Just as volatility and high prices might make some investors leery of stocks now (see "Buy-write strategies for a flat market"), the threat of rising interest rates may worry fixed income investors. Rising rates tend to depress bond prices.

Again, a time-tested strategy might be useful in the current environment. You could put together a bond ladder to hold the fixed income portion of your asset allocation. A ladder might consist of many individual issues with staggered maturities. As the nearest "rung" on your ladder is redeemed, the proceeds are reinvested in a bond with a longer maturity.

Example 1: Paula Morris decides to allocate $200,000 of her fixed income holdings to a bond ladder. She invests $25,000 in bonds maturing in 2019, $25,000 in bonds expiring in 2020, and so on, out to 2026. Typically, the longer the maturity, the higher the bonds' yields and the greater the exposure to price drops if interest rates rise.

When the bonds that make up Paula's 2019 rung are redeemed at maturity, she invests the $25,000 proceeds in bonds maturing in 2027, and so on, year after year.

Flex Plan

With such a ladder, Paula will have $25,000 worth of bonds maturing each year. If interest rates rise in the future, as many observers expect, Paula will be able to buy higher yielding bonds, raising her periodic cash flow from investment interest.

Conversely, interest rates might surprise the "experts" and move lower. Paula will be re-investing at a lower yield, it's true, but she likely will be glad that she has locked in higher-than-current yields with her bonds on the later rungs.

Ultimately, Paula will wind up with a ladder that comprises bonds that were all bought at 8-year maturities. Historically, that has been a relatively attractive place on what is known as the yield curve, a plot of yields and maturities. Eight-year bonds often have yields much greater than those of very short-term bonds as well as moderate exposure to rising rates. That is, a bond issued with an 8-year maturity may not suffer a price drop as steep as a 10- or 20-year bond will experience, if interest rates trend much higher.

Taxable Or Tax-Exempt

Investors often use tax-exempt municipal bonds for their bond ladders. If so, the bond ladder should be held in a regular taxable account to take advantage of the tax break. Bonds issued within the buyer's state of residence often avoid state or local income tax as well as federal tax.

For IRAs and other tax-deferred retirement accounts, bond ladders generally should be constructed from corporate bonds or other taxable issues. Yields generally are higher than they are in comparable municipal bonds, and those yields can compound inside the tax-deferred plan.

Either way, if you are building a bond ladder now, buying existing, rather than newly issued, bonds, be aware that older bonds generally trade at a premium because they have higher yields than today's new issues.

Example 2: When Paula puts together her bond ladder, she pays $27,500 to buy bonds maturing in 2026 with a face value of $25,000. She builds in a $2,500 loss in return for receiving above-market yields for the next eight years, up until maturity.

You shouldn't expect huge profits from a bond ladder. Instead, you should consider a bond ladder as an arrangement that could possibly improve portfolio income and stability over a long period of time. Every year, you can expect an untaxed bond redemption that you can spend or save as you choose.

Trusted Advice
Bond Premium Taxation

- If you pay more than face value to buy tax-exempt bonds, you must amortize the premium each year. The amount of the tax-exempt interest from the bonds that you report on your tax return is reduced by the amortized amount.

- Amortization of the premium reduces your basis in the bond by the amortized amount; the amortized amount is not deductible.

- If you pay more than face value to buy taxable bonds, you can choose to amortize the premium. If you choose to do so, the amortized amount is deductible, and your basis in the bonds is reduced by the amortized amount.

- If you choose not to amortize the premium on taxable bonds, the premium will create a tax loss when the bonds are redeemed at face value.