WELLS FARGO Advisors

Bond laddering

An income strategy for all interest-rate environments

Ladders are typically built using:

- U.S. Treasury and government-agency securities
- Tax-exempt municipal bonds
- Corporate bonds
- Zero-coupon bonds
- Certificates of deposit*
- Ginnie Mae pass-through securities

A bond ladder spreads investment dollars among bonds that mature at various times between one year and 30 years. Laddering bonds enables investors to reinvest assets periodically over time to help reduce the effect of interest-rate volatility in fixed-income portfolios. Bond laddering can be an effective strategy when purchasing bonds of staggered maturities to offset fluctuating interest rates, increase portfolio diversification, and fulfill specific funding requirements.

Think of individual bonds as rungs on a ladder. In normal interest-rate environments, bonds with shorter maturities will yield less than longer maturities. As each individual bond in the ladder matures (bottom rung), the principal then becomes available for reinvesting, at current interest rates, into bonds of intermediate or longer-term maturities with the higher yields. The new bonds then become the new “top rungs” of the ladder. This concept is similar to dollar cost averaging in stocks.

A way to address changing interest rates

Bond ladders can potentially reduce the effect that fluctuating interest-rate environments have on investment portfolios. Here’s why:

- If interest rates go down over the next few years, bonds with higher rates are locked in — and the current market value of your fixed-income portfolio should rise.
- If interest rates stay the same, the investor earns longer-term yields, so returns should exceed those of shorter-term investments.
- If interest rates go up, the current market value of the fixed-income portfolio will be falling. However, as each rung on the ladder matures, principal will become available to invest at higher rates.

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Another potential advantage of investing in bonds of staggered maturities is that bond ladders can be customized for individual investment objectives, such as future funding needs or fulfilling specific income requirements. For example, investors may stagger zero-coupon Treasuries or other types of bonds maturing in late summer to fund a private or college education. Often, retired investors will ladder bonds to help generate a relatively stable, monthly income stream. Investment selection will also take into account such things as tax liabilities, quality considerations, and anticipated future changes in the investor's financial situation.

Ideas for using a bond ladder:

- Use zero-coupon Treasury bonds maturing in August to fund private school or college education.
- Build tax-exempt municipal ladders to help reduce federal income taxes in higher tax brackets.[1]
- Invest in pass-through securities (Ginnie Maes) as to the timely payment of principal and interest, to help provide a monthly income stream.
- Use diversified bonds for pension and profit-sharing or IRA accounts.
- Select Treasury notes for endowment funds.

Potential benefits of bond ladders

Diversification. Bond ladder investors purchase a variety of bonds to provide diversification, which can reduce credit risk[2] and reinvestment risk.[3] In addition to selecting a number of different maturities, investors can select from a variety of investment types or ratings. Diversification does not ensure a profit or protect against loss.

Higher yields. Many investors are reluctant to buy longer-term bonds. However, in a normal rate environment, intermediate and longer-term securities offer higher yields than short-term securities. The liquidity and diversification provided by a well-structured bond ladder will enable investors to include longer, higher-yielding securities to potentially increase the portfolio's overall return.

Investors should be aware of the call features on their bonds and how they may negatively affect the structure of the bond ladder. Callable bonds can offer higher yields than comparable noncallable bonds. If a bond ladder contains all callable bonds, the call features should be taken into consideration to avoid a large portion of bonds being called at one time if rates happen to be lower. The principal would then be reinvested at lower rates. Reinvestment risk can be minimized by structuring the ladder to include noncallable bonds or staggering the call dates.

Liquidity. With a ladder, bonds will mature regularly. Proceeds can then be reinvested in the ladder or taken out in cash if needed.

Quality. With a well-diversified bond ladder, investors can vary the portfolio's quality, hopefully increasing its yield as a result. Remember, the risk tolerance of the investor should dictate the overall quality of each bond ladder.

Customization. Bond ladders can be designed today to help meet current financial needs, whether for savings or income generation. Laddering a portfolio is a dynamic process that gives investors the opportunity to restructure as needs and objectives change — such as systematically moving from tax-exempt to taxable investments upon a change in tax status.[4]

1. Income may be subject to state or local taxes or the alternative minimum tax (AMT).
2. Credit risk refers to the risk of the issuer failing to make timely payment of principal and interest.
3. Reinvestment risk is the risk that you may have to reinvest proceeds at a rate below that of the original investment.
4. Wells Fargo Advisors does not render legal, accounting, or tax advice. Please consult your tax or legal advisors before taking any action that may have tax consequences.

Summary

A bond ladder can be a valuable addition to your fixed-income portfolio. This strategy uses diversification, offers higher potential returns, and helps reduce fixed-income investment risks. Your financial advisor can help you determine whether a bond ladder suits your investment objectives and which types of structures are most appropriate for your investment needs. For more information about bond ladders and your portfolio, consult your financial advisor today.

Wells Fargo Advisors is not a legal or tax advisor. However, its financial advisors will be glad to work with you, your accountant, tax advisor, and/or lawyer to help you meet your financial goals.

Investing in fixed-income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed-income investments may be worth less than original cost upon redemption or maturity.

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price.

Bond laddering does not assure a profit or protect against loss in a declining market. Yields and market values will fluctuate, and if sold prior to maturity, bonds may be worth more or less than the original investment. All investing involves risk, including the possible loss of principal.

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