Investing in Bonds – Factors and Risk Considerations

The following disclosure is being provided by INSIGNEO related to the risks and considerations when investing in bonds.

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Bonds (also referred to as “fixed income securities”) represent an asset class of securities offering investors defined cash flows and a specific time line for return of principal dollars invested. In general, specific characteristics define bonds as one of the most predictable asset classes and thus more conservative means to protect an investor's wealth and/or provide steady income. That being said, there are risks and benefits associated with any investment which need to be understood in order to meet individual needs and investment suitability.

Professional advice and, in many cases, professional management, are key elements of successful financial planning. Although there is no assurance any investment strategy or product investment will be successful, our registered representatives assist investors in creating diversified fixed income portfolios designed to perform in various market environments while addressing the investors' specific objectives for level of income and principal preservation.

Asset allocation and diversification do not ensure a profit or protect against a loss. Investment suitability must be determined for each individual investor. Market prices of fixed income securities may be affected by several types of risk, including, but not limited to credit risk, interest rate risk, reinvestment risk, and liquidity risk. Investing involves risk and investors may incur a profit or loss. Depending on the type of fixed income security such market instruments are subject to several types of risk, including but not limited to:

Interest rate risk

The basic relationship that holds true for most fixed-income securities is that price moves in the opposite direction of interest rates. For example, when interest rates rise, the price of the security will fall. Conversely, when interest rates decline, the price of the security will rise. This risk is commonly referred to as market, or interest rate risk. The price sensitivity for a particular security to a change in interest rates depends largely on characteristics such as the coupon, the maturity date, and all call features.

Duration risk

The duration of a bond is a measure of its price sensitivity to interest rates movements, based on the average time to maturity of its interest and principal cash flows. Duration enables investor to more easily compare bonds with different maturities and coupon rates by creating a simple rule: with every percentage change in interest rates, the bond's value will decline by its modified duration, stated as a percentage. For example, an investment with a modified duration of 5 years will rise 5% in value for every 1% decline in interest rates and fall 5% in value for every 1% increase in interest rates.

Bond portfolio managers increase average duration when they expect rates to decline, to get the most benefit, and decrease average duration when they expect rates to rise, so minimize the negative impact. If rates move in a direction contrary to their expectations, they lose.

Liquidity (or Market) risk

Liquidity risk refers to the risk that an investor may not be able to sell a security quickly at is fair value. Investors should be aware of the liquidity risk of the market as a whole, in addition to the liquidity risk of particular securities. Even though the liquidity of a particular issue may be high, at times the market itself may be less liquid.

Financial (or Credit) risk

A bonds issuer's ability to pay its debts – that is, make all interest and principal payments in full and on schedule— is an important influence on the value of its fixed-income securities. The credit ratings assigned by the major rating agencies, such as Moody's Investors Services, Standard & Poor's Corp., and Fitch Ratings are widely accepted measures of the credit risk of a particular security. Accordingly, a change in the credit rating of an issuer (or the expectation of a change) would generally affect the price of its bonds. A credit downgrade would be viewed as a negative and would tend to decrease the price of a bond; similarly, a credit upgrade would tend to raise the price of the bond . Determining the appropriate level of credit risk for a portfolio depends largely on the situation of the particular investor. Generally, for an investor who is concerned with preservation of capital, high credit quality should be a priority.

Call risk

Fixed-income securities are often issued with a call provision. From the investor's perspective, there are three major disadvantages associated with a call provision. First, the cash flow stream is not known with certainty. From the investment strategy standpoint, this creates a problem with identifying the proper time horizon. Since a security is callable before maturity, the actual duration of it is less than its duration to maturity, but more than its duration to call. Another disadvantage associated with callable securities is that the issuer will generally call bonds when interest rates have declined, leaving the investor to reinvest the proceeds at an inopportune time. Finally, the price appreciation of "callables" is limited since the price of a callable issue does not rise much above its call price. Unfortunately, the same is not true for the downside price risk. The price of a callable issue can fall far below its call price given a substantial rise in interest rates.

Re-investment risk

Re-investment risk refers to the risk that interest payments and re-payment of principal would need to be re-invested in a low interest-rate environment, and, therefore, give the investor a lower total rate of return than might have been expected when the security was originally purchased. The income received from the re-investment of coupon payments can be an important element in the total return from a security, particularly long-term issues.

Inflation (or purchasing power) risk

Most fixed-income securities are designed to provide a stream of interest payments over time, plus the return of your principal at maturity. The drawback, however, is that you do not know what the purchasing power of those payments will be in the future. This risk is commonly referred to as inflation risk. Inflation risk is the likelihood that inflation will erode the value of those payments over time. A rise in inflation would generally push up yields and reduce the price of the security. Inflation risk is higher the longer the maturity of the fixed-income security. One way to counteract inflation risk is to stagger maturities or build a portfolio ladder. With a ladder, maturing funds can be re-invested as they mature. If inflation rises, yields are likely to rise as well, so the maturing funds can be re-invested at higher yields.

Event risk

The risk that a bond's issuer undertakes a leveraged buyout, debt restructuring, merger or recapitalization that increases its debt load, causing its bonds' values to fall, or interferes with its ability to make timely payments of interest and principal. Event risk can also occur due to natural or industrial accidents or regulatory change. (This risk applies more to corporate bonds than municipal bonds.)

Legislative risk

The risk that a change in the tax code could affect the value of taxable or tax-exempt interest income.

Early amortization risk

Early amortization of asset-backed securities can be triggered by events including but not limited to insufficient payments by underlying borrowers and bankruptcy on the part of the sponsor or servicer. In early amortization, all principal and interest payments on the underlying assets are used to pay the investors, typically on a monthly basis, regardless of the expected schedule for return of principal.

Market risk

The risk that the bond market as a whole would decline, bringing the value of individual securities down with it regardless of their fundamental characteristics.

Selection risk

The risk that an investor chooses a security that underperforms the market for reasons that cannot be anticipated.

Timing risk

The risk that an investment performs poorly after its purchase or better after its sale.

Risk that you paid too much for the transaction

The risk that the costs and fees associated with an investment are excessive and detract too much from an investor's return.