STAFFORD WELLS
personal wealth management newsletter

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Dear Clients & Friends,

What My Mother-in-law Taught Me about Personal Finance

When my mother-in-law was 86 years old, she mentioned one evening over dinner that she had always wanted a Jaguar car. At the time, she resided in a condo within a retirement community, had all her faculties (plus some) and was physically and socially active. She also had more than enough assets to see her through the rest of her life. Within the next seven days of that conversation, her children took her out and had her buy herself a beautiful convertable Jaguar sedan with a leather beige interior.

Clearly, it was a thrill to see this woman have something that she had always wanted. But what was clear to me was that she could have had this car all along. She could have had this car at age 45, when perhaps she would have enjoyed it even more. However, she was being frugal all those years and putting off the things that cost money.

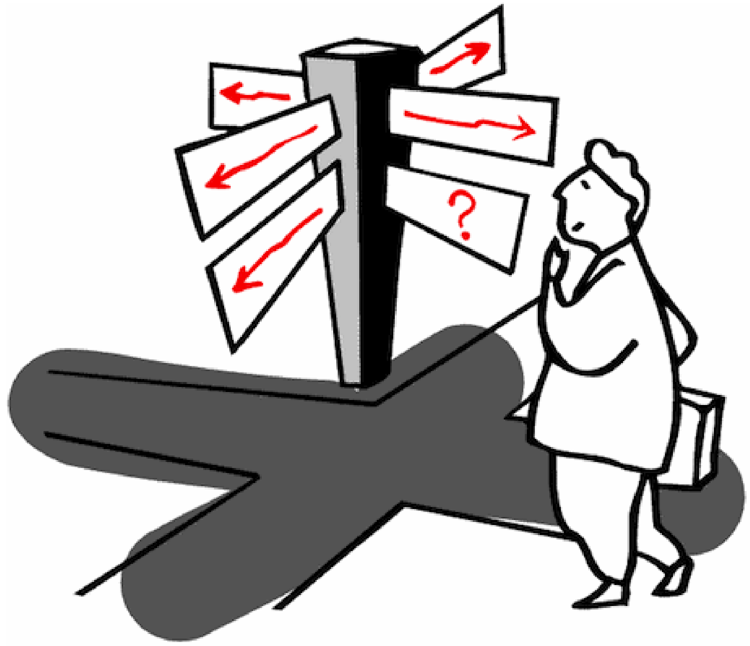
We keep hearing about how Americans are not saving enough for retirement and how senior citizens have not planned accordingly and are now broke. There is another contingent: the individuals who forgo many of life’s pleasures as they are afraid to enjoy what they have worked hard for. When they finally realize they can afford some of the items they have been longing for, they have lost interest or the thrill is not there anymore.

Some people are just frugal or cannot sleep at night until they have far more money in the bank than they will ever spend. However, there are many who just do not know how much they need to have to make it to the end. This was my mother-in-law. She never had to handle a budget or family finances. She had no idea as to how much she had in assets or how much she could safely spend.

This story gives us two lessons we can learn. First, we should do some financial planning so that we know financially where we stand in providing for ourselves through retirement. And second, we should not put off the things that bring us joy if we can afford them now.

Owning a Bond Fund Versus Individual Bonds in a Rising Interest Rate Environment

It may be a surprise to you that in a rising interest rate environment, you might be better to hold a bond fund than a few individual bonds. Here is the math that supports the argument…



Experts have been telling investors to sell their bond funds and if they want fixed income exposure, to buy individual bonds, because this will protect investors from rising rates. Intuitively, it makes sense, as if you own a bond and interest rates rise, the bond's value declines. But, if you hold the bond until maturity, eventually, you recoup 100 percent of the principal.

Consider the following example:
You hold a 10-year bond, which you bought for $1,000. It pays a 2 percent annual dividend . After you buy the bond, the interest rate on equivalent 10-year bonds rises to 4 percent. This makes the original bond's value decline to $836. You can continue to hold the bond and earn 2 percent and receive the $1,000 principal until maturity. Now suppose a mutual fund whose managers actively buy and sell bonds incurs the same situation. The fund's managers choose to sell the bond for $836 and invest the proceeds in a new 10-year bond that carries a 4 percent coupon. The fund's managers take the proceeds from the sale of the 10-year bond, with a 2 percent yield, which is $836, and buy a 10-year bond with a 4 percent coupon. Since the fund only has $836, the managers can only purchase a portion of a $1,000 bond, which equals $836/$1000 = 83.6 percent. This new bond's dividends are $33.46, not $40, as the fund owns only $836 of this bond. Upon maturity, the bond fund receives $836.

In either scenario, the IRR (internal rate of return) is the same--2 percent--if you hold the individual bonds or invest in a bond fund--assuming the durations are equivalent.

The benefits to the holder of the individual bond are if they sell the bond, they can take a capital loss on their taxes in the year that it was sold. The benefits to holding a fund include having a diversified portfolio of many bonds, transaction costs are minimized due to institutional trading efficiencies, and a bond fund manager is more likely to find valuable bonds at good prices than an individual investor.

So don't rush out and sell your bond funds and buy individual bonds without considering these tradeoffs.

As always, thank you for your continued support, and please contact me if I may be of any assistance.

My Best,

Lauren Templeton