3 principles of individual fixed-income investing

There's more to bond investing than focusing on current interest rates. By focusing on our three investment principles, you should be better positioned to achieve reliable income and less principal fluctuation and to help reduce overall portfolio risk.

1.	**Focus on quality**
2.	**Focus on diversification**
3.	**Focus on investing for the long term**

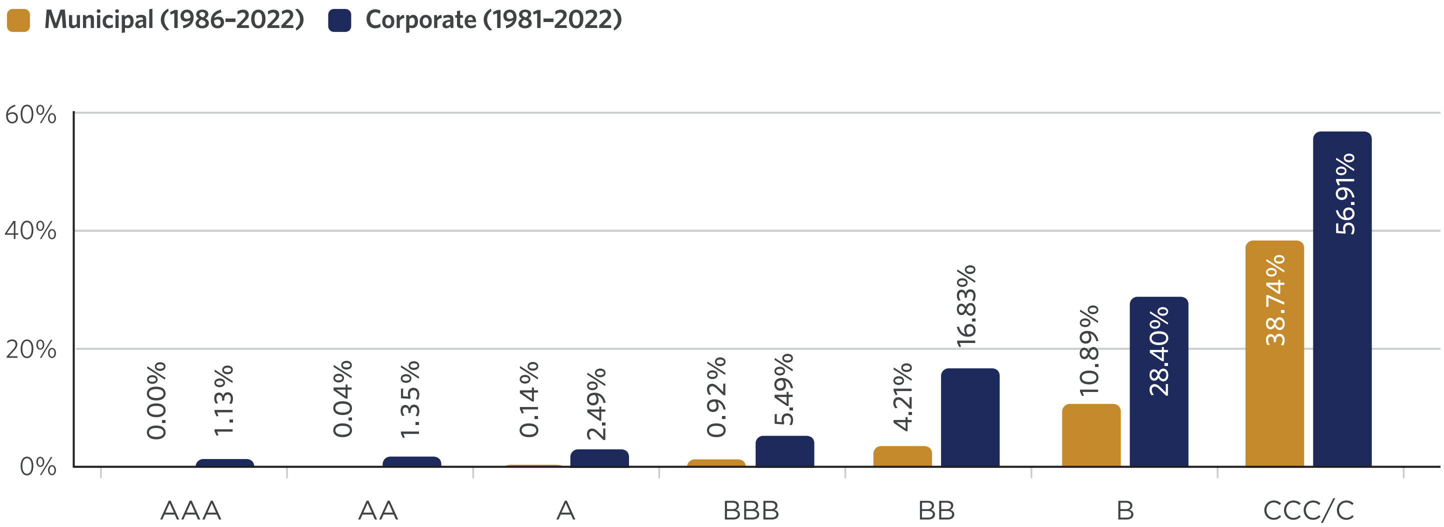
When are individual bonds appropriate?

We recommend clients consider individual bonds only if they have at least $50,000 to allocate to the income investment category. This allows for proper diversification by building a portfolio of at least 10 bonds in minimum increments of $5,000. Clients with smaller portfolios or who are seeking exposure to aggressive income or international fixed income should consider bond funds, exchange-traded funds (ETFs) or unit investment trusts (UITs).

1. Focus on quality

Reliable income is an important goal for most bond investors. When buying bonds, don't be tempted by lower-quality bonds paying higher rates because of the increased risk these bonds will fail to make interest payments, as shown in the following table.

U.S. average cumulative default rates



Source: Standard & Poor's. Time horizon = 15 years.

Since higher-quality bonds have a lower default risk, we recommend 85% of your fixed-income portfolio be composed of bonds rated AAA, AA or A. Though bonds with a BBB rating are investment-grade quality, they should make up only a small portion of your portfolio.

Credit ratings can change over a bond's life. Bonds rated AAA, AA or A have more cushion before reaching non-investment-grade status if the bond is downgraded. A downgrade from BBB to BB+ or lower puts a bond below investment grade, and the risk of failing to make timely interest and principal payments increases. A bond that has declined in credit quality may have a significantly lower market price at the time of sale.

Certificates of deposit (CDs) are insured by the Federal Deposit Insurance Corporation (FDIC) up to applicable limits. The standard FDIC insurance amount is $250,000 per depositor, per insured bank, for each account ownership category. Account ownership categories include single, joint, retirement and trust accounts, among others.

CD holdings above these limits may not be covered by FDIC insurance. We generally recommend limiting CD holdings to FDIC limits, including principal and interest. CD holdings above FDIC limits, also known as uninsured deposits, are subject to the issuing bank's financial strength and may result in loss of principal and interest. Additionally, CD rates reflect the backing of FDIC insurance, so uninsured deposits may offer an unfavorable risk-return trade-off.

It's important to review your fixed-income investments periodically to make sure they still align with your goals and comfort level with risk.

2. Focus on diversification

You should strive to diversify your fixed-income investments. A broad-based bond fund or ETF can offer fixed-income diversification and professional management. If you own individual bonds, work toward ensuring no more than 5% of your total portfolio is invested in any one issuer and that your portfolio is diversified among the different categories of bonds.

Diversify by issuer

Owning bonds from a variety of issuers can help reduce overall risk. Work to ensure that no single obligor — the issuer making interest and principal payments — makes up more than 5% of your total investment portfolio.

Diversify by category

Three primary categories of bonds are government, corporate and municipal. Owning bonds across categories can help balance bond credit quality and your income needs.

Government — Government bonds include U.S. Treasury bonds, Treasury Inflation Protected Securities (TIPS), FDIC-insured CDs and government-sponsored enterprises (GSEs) such as Fannie Mae, Freddie Mac, Federal Home Loan Bank and the Tennessee Valley Authority (TVA). Because these bonds possess high credit quality, including them in your portfolio is a good way to enhance the overall quality of your fixed-income holdings. Historically, they've given investors relatively stable returns due to their relatively low level of risk. Keep in mind that past performance is not a guarantee of future results.

In addition, U.S. Treasury bonds, CDs and TIPS are typically noncallable, meaning the issuer can't redeem the bond before its maturity date. Therefore, they can help improve the overall call protection of your portfolio.

Corporate — Corporate bonds are categorized in three sectors: financial, industrial and utility. We recommend that you consider owning bonds from each sector. That way, if a particular sector experiences some problems, you'll own other bonds that likely aren't affected by the same factors.

Corporate sector recommendations

	Recommended range
Financial	30% – 45%
Industrial	35% – 55%
Utilities	10% – 25%

The primary reason most people own bonds is for the income they provide and the promise of their principal being returned at maturity. As stated before, a bond's interest rate shouldn't be the primary reason you purchase it. Even if it means accepting a slightly lower interest rate, you should ensure your bonds are appropriately diversified across sectors.

Focus on diversification *(continued)*

Municipal — When buying municipal bonds, start with general obligation (GO) bonds. Historically, these have lower default rates than other muni bonds. We recommend GO bonds make up a large portion of your municipal holdings. Among the other types of muni bonds, consider those of different municipalities and sectors: utilities, tax-backed, transportation, etc.

Recommended ranges for muni bonds

Bond type	Recommended range
General obligation (GO)	30% – 80%
Total revenue bonds	20% – 70%
Tax-backed	5% – 20%
Utilities	10% – 25%
Transportation and other	5% – 20%
Education	0% – 10%
Health care	0% – 5%
Housing	0% – 10%

Making sure your bonds aren't all from one state or region can also help you reduce risk. In some cases, depending on your tax rate and current market conditions, the after-tax return of an out-of-state bond may not be too different from that of a bond from your own state. In that case, it may be a good strategy to accept a slightly lower rate to diversify into bonds from other states.

If you're looking for current income, work with your financial advisor to determine which types and amounts of bonds are appropriate for you. Diversification is key in helping ensure your portfolio can weather any market ups and downs. Keep in mind, however, that diversification does not guarantee a profit or protect against loss in a declining market.

3. Focus on investing for the long term

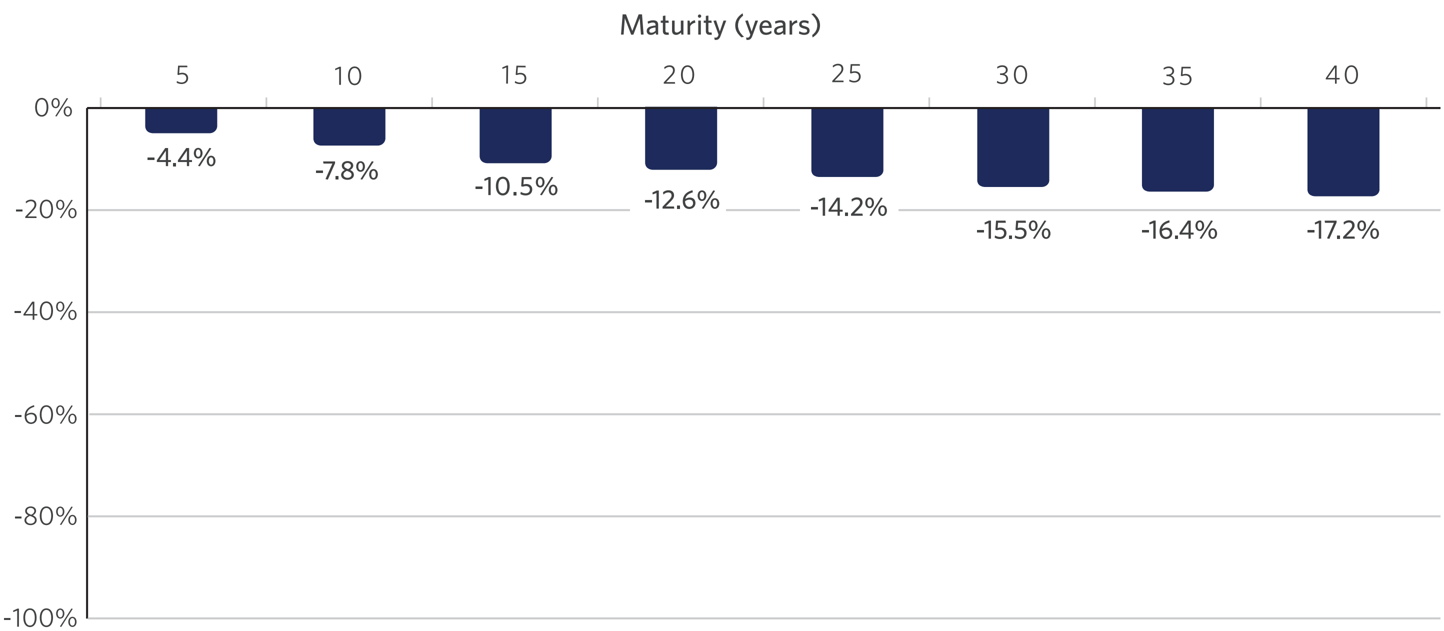
We recommend buying bonds with the intention of holding them until they mature or are redeemed by the issuer. Bonds can provide interest payments and a return on principal. Although it can be tempting to time the market as interest rates and bond prices change, we believe you should buy bonds for the current income they provide.

Bond prices and interest rates

Bond income is usually fixed, but interest rates can cause a bond's market value to vary — bond prices typically fall when interest rates rise. The opposite is also true, although bonds that can be called by the issuer have limited opportunity to appreciate in price because the call acts like a ceiling, keeping prices from rising. The longer the maturity, the more sensitive bond prices are to rate changes. This relationship affects only the market value, or the approximate amount received if you sold a bond prior to maturity. The interest payments received are not affected. If you hold a bond until maturity, you can still expect to receive the original face amount.

Longer-term bond prices fluctuate more than shorter-term bonds. The example below shows how much prices of bonds with a 4% rate would fall if interest rates rose 1%. With a 2% rate increase, price declines would nearly double.

Price decline for a 1% rise in interest rates for a 4% coupon bond



Source: Edward Jones calculations. This example is for illustration only and does not represent any currently available investments.

Focus on investing for the long term *(continued)*

Help manage risk with laddering

Laddering means investing in a variety of bonds with short-, intermediate- and long-term maturities. This long-term strategy helps manage risk and doesn't depend on rising or falling interest rates for success. It can also help balance the risks of price and income changes to smooth wide swings in your income and principal. Bond laddering doesn't ensure a profit or protect against loss. Evaluate the securities within the bond ladder to ensure they align with your investment objectives, risk tolerance and financial circumstances.

Bond ladder recommendations

Maturity type	Recommended range
Short term (up to 5 years)	30% – 40%
Intermediate term (6 to 15 years)	40% – 50%
Long term (16+ years)	15% – 25%

Watch the call

Some bonds are callable, meaning the issuer can redeem the bond before its maturity date. It's more difficult to ladder with callable bonds because you don't really know how long you'll own them. Callable bonds typically offer a slightly higher rate to compensate for the risk of the bond being redeemed early. This risk can increase significantly if interest rates fall but is generally lower when interest rates rise. This call feature benefits the issuer, which can refinance the bond at a lower rate.

Callable bonds increase your reinvestment (or income) risk. If a bond is called and interest rates are lower, you'll have to reinvest your money at a lower rate. When possible, limit your number of callable bonds and provide some variety in the call dates of those you own. Noncallable and make-whole call bonds* should be included in bond portfolios when appropriate to help diversify the risk associated with callable bonds.

*A make-whole call provision allows bonds to be called at any time, but issuers have to pay a higher premium to redeem bonds when interest rates are declining. It makes bondholders "whole" by providing compensation for missed interest payments due to the call. Since issuers aren't expected to use a make-whole call, it provides better call protection for investors than with typical callable bonds.

Before investing in bonds, you should understand the risks involved, including interest rate risk, credit risk and market risk. The value of bonds fluctuates, and you may lose some or all of your principal.

