

HEADWATER INVESTMENT CONSULTING, INC.

Registered Investment Advisor

INVESTING WITH DISCIPLINE

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BONDS...TREASURY BONDS

By Brian Lawrence, CFA

It doesn't have the same ring as *Bond...James Bond*; however, bonds can be more exciting than you might first expect. Let's examine what bonds are, the structure of the bond market, the risks involved and the reasons to own them.

What is a bond? At the highest level, a bond is simply a contract between the issuer and the purchaser of the bond—the investor lends money and the issuer promises to pay interest and principal on certain dates. For example, the U.S. government issues treasury bonds which promise to pay investors interest twice a year and return their principal at the maturity of their bond.

Bond Market Structure. Bond markets have a large influence on both the economy and your portfolio. The U.S. bond market is worth \$31 trillion or 38% of the total global bond market of \$82 trillion dollars, with the largest segments of this market being municipals, treasuries, and corporate bonds. Each segment of the market carries different risks and returns as well as different tax treatments.

Municipal—issued by the city, state, school district, etc, to construct roads, sewers, schools, stadiums and usually offers both federal tax and state tax exemption, if you buy the bond within your own state.

Treasury—issued by the U.S. Treasury which is considered the safest of all investments and offers state and local tax exemption.

Corporate—issued by private and public corporations for business expansion. They are taxable at both the state and federal level.

INDEX SCORE-CARD

QUARTERLY RETURNS

	4 th	1 st
US Large Cap:	6.0%	5.4%
US Small Cap:	3.9%	8.8%
International Stocks:	2.2%	0.9%
Emerging Markets:	8.3%	2.1%
US Bonds:	0.2%	1.8%
Foreign Bonds:	-1.3%	-0.9%
REITs:	9.4%	10.0%
Commodities:	9.0%	-5.0%
TIPS:	1.8%	-0.02%
Treasury Bills:	0.02%	0.03%

4th Quarter for the period ending
12/31/2009

1st Quarter for the period ending
3/31/2010

CONTACT

For more information regarding
Headwater Investment Consulting,
please contact us:

TEL: 503-565-2100
FAX: 503-565-2101
info@headwater-ic.com

2290 SW 2nd, Suite A
McMinnville, OR 97128

Or visit our website:
www.headwater-ic.com

WIT & WISDOM

"Shocking. Positively shocking."

James Bond

played by Sean Connery, Goldfinger (1964)

BONDS...TREASURY BONDS (CONTINUED)

S&P	RISK	GRADE
AAA	Lowest Risk	Investment
AA	Low Risk	Investment
A	Low Risk	Investment
BBB	Medium Risk	Investment
BB	High Risk	Junk
B	High Risk	Junk
Below B	Highest Risk	Junk
NR/NA	In Default	Junk

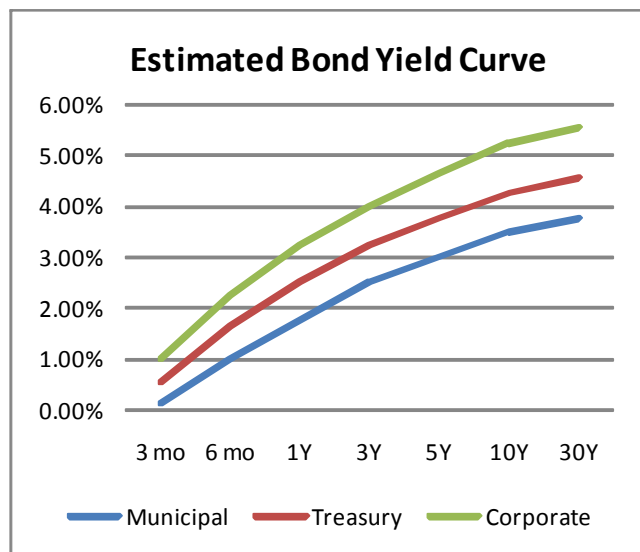
Bond risks. Not all bonds are created equal. As previously stated, there are many segments in the bond market, each with their unique risks and

characteristics. How do we define risk? The above chart illustrates how bond rating agencies assign a letter grade that indicates relative riskiness of a bond. For example, the federal government is generally recognized as the safest issuer in the bond market. The municipal and corporate sections of the bond market are more complex, carry more risk, and therefore have a rating that ranges from AAA to issuers in default.

Besides credit risk, there is also interest rate risk. As interest rates rise, the prices of bonds fall and vice versa. If you buy a bond today and interest rates then go up, bonds purchased tomorrow at the higher rate are more attractive than bonds bought at the lower rate yesterday. This risk can be quantified by duration. Duration is a measure of a bond's price volatility. Now what affects duration? Longer term bonds have higher risk than shorter term bonds. This is due to both interest rates and coupon payments. Coupons are the annual or semi-annual payments received from a bond until it matures. Higher coupon bonds have a lower risk. As the coupons get closer to zero, they have higher volatility. Zero coupon bonds have the highest level of risk as the investor receives no coupon payments and the yield received is only the difference between the face value of the bond and the current market value at the time of maturity.

Interest rate risk goes up as the maturity date goes further and further into the future. Intermediate

term bonds earn more than short term bonds and long term bonds earn even more than both short and intermediate, as the graph shows below. The longer you own a bond, the longer you are exposed to the risks of ownership. To compensate for that risk, owners demand a higher yield.



Reasons to own bonds. Relative to other investments, bonds provide a degree of stability, and depending on the type of bond owned, it could provide the investor a tax advantage. From a portfolio management standpoint, bonds provide a valuable source of funds. When stock markets are in crisis and it's desirable to rebalance a portfolio, i.e. buy more stock, the income from bonds can be used to bring a portfolio back to its target allocation. Therefore, bonds aren't always exciting, but they do provide a crucial role in most investors' portfolios.

We hope this dispels any mystery or misunderstanding about bonds. If you have any questions, please don't hesitate to call or set up an appointment to discuss.

INDEX LIST

- US Large Cap:** S&P 500.
- US Small Cap:** Russell 2000.
- International Stock:** MSCI EAFE.
- Emerging Markets:** MSCI Emerging Markets Index.
- US Bonds:** Barclays Capital Aggregate Bond Index.
- Foreign Bonds:** Barclays Capital Global Aggregate Bond Index.
- REITs:** FTSE NAREIT Composite Index.
- Commodities:** Dow Jones UBS Commodity Index.
- TIPS:** Barclays Capital US Treasury Inflation Protected Securities Index.
- Treasury Bills:** Short-term government issued securities with maturities less than 90 days.

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