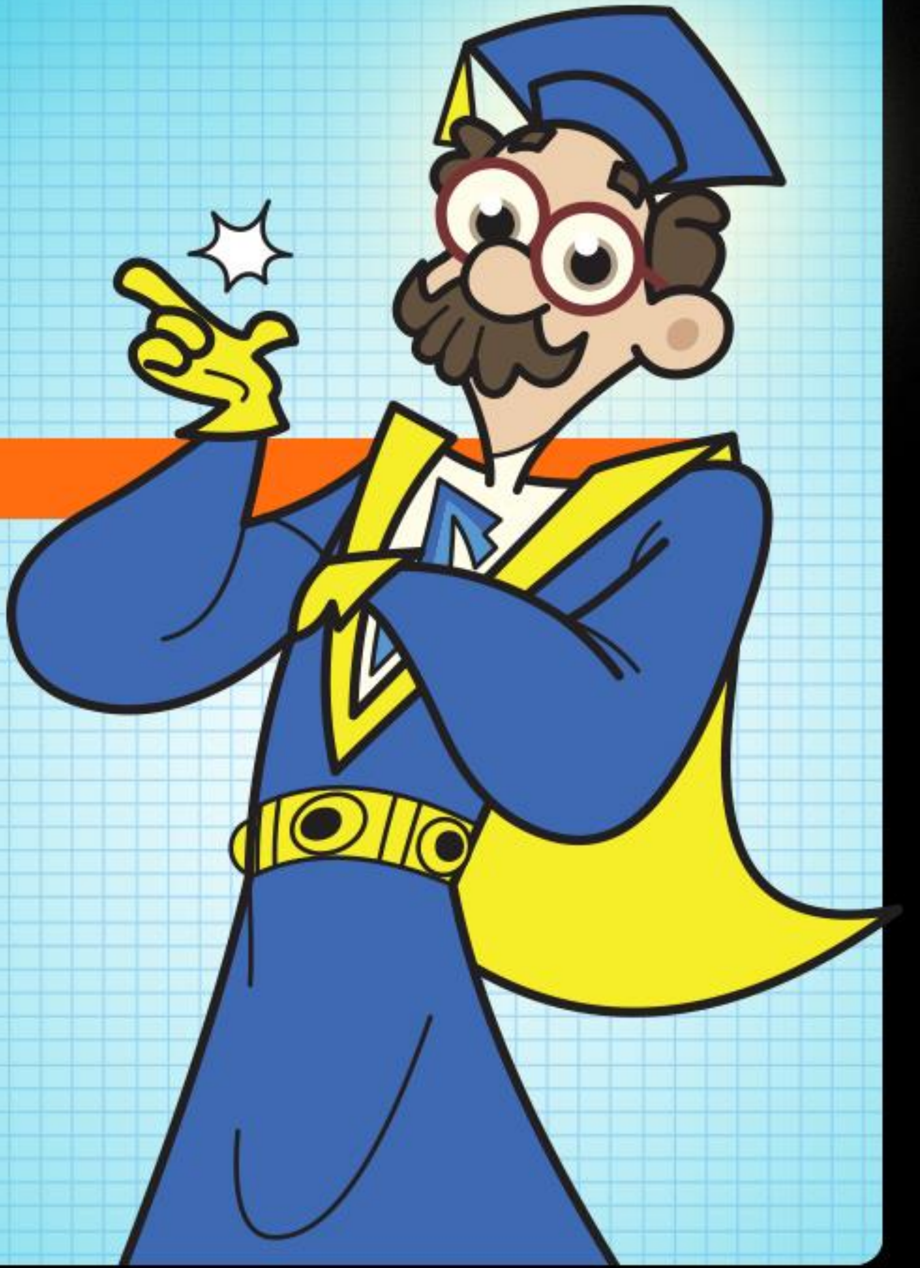
BOND LADDERING



BOND LADDERING

Bond investing is much like a game of musical chairs in which bond prices move to the tune of interest rates. Sometimes you might feel that you have no control over what happens to your bond portfolio with the future movements in interest rates.

But familiarity with ‘bond laddering’, an investment strategy, could help deal with what is called reinvestment risk.
I will try to explain ‘Bond Laddering’ as a concept to you in the next few slides…

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Understanding Bond Laddering

– By Prof. *Simply* Simple ™

BOND LADDERING

- A bond ladder or bond laddering is an investment strategy based on a very simple concept.

- It tries to minimize the risk associated with the future movements in interest rates while creating a regular flow of money for the bond holder.

- A bond portfolio using laddering would consist of bonds having different maturity dates at regular intervals.

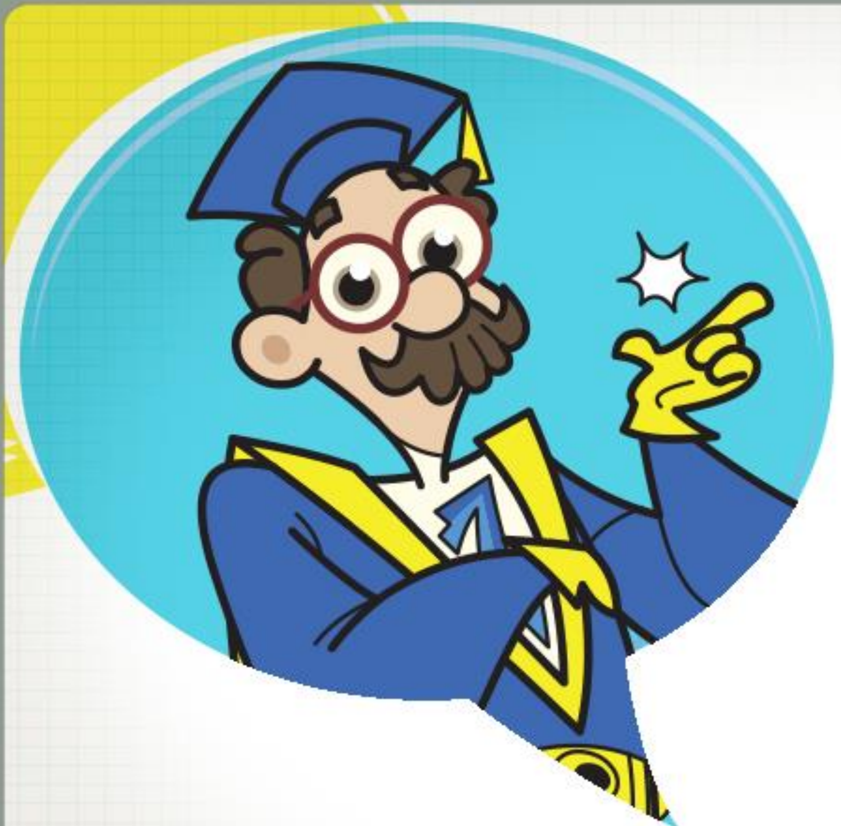
BOND LADDERING

However…

- **The face value of each bond might be same.**
- **For example, a bond portfolio of Rs10 lakh may have 10 different bonds of Rs1 lakh each maturing after one year, two years, three years and so on.**
- **In such a situation, your bond portfolio would actually look like a ladder in which every year some of your bonds would be maturing, generating a steady cash flow**
- **This cash flow, if you so like, can be reinvested again to create another rung of a bond ladder.**

This kind of strategy ensures that your entire bond portfolio does not mature on the same date.

BOND LADDERING



Okay, but how does it work?

BOND LADDERING

- A bond ladder strategy is very useful in dealing with one of the most common risks facing your bond portfolio: Reinvestment risk. How?
- Well, reinvestment risk of a bond is something that arises due to future movements in interest rates.
- Suppose you hold a bond portfolio which is currently earning you an interest of 8%.
- Your bonds would continue to earn an interest of 8% till the date of maturity.

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Now…

- **In the meantime, interest rates might not remain static.**
- **They can very well go up or down. In case you choose to hold your bonds till maturity, your entire portfolio would be maturing on the same day.**
- **This means that you can reinvest your money only at the interest rates prevailing in the future.**

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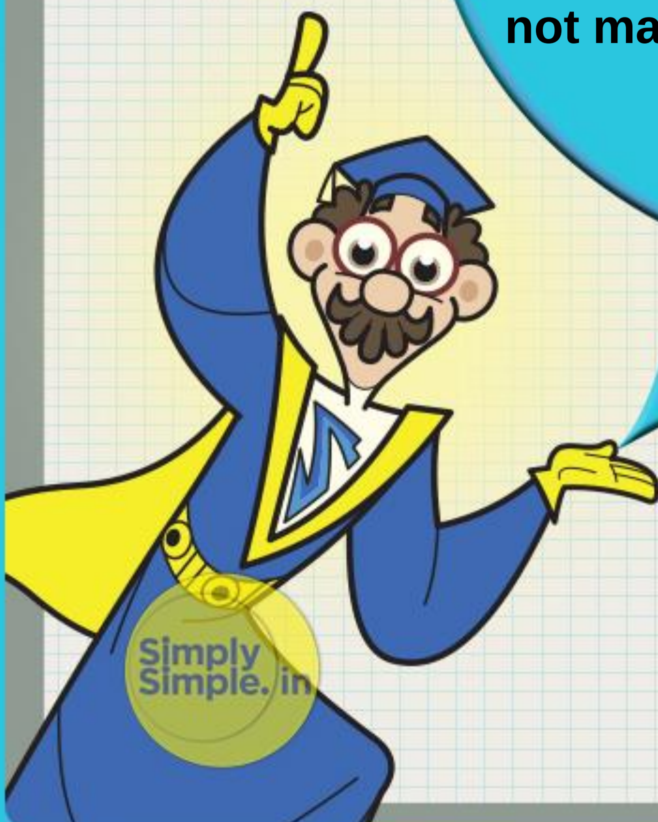
- In case the rates are higher, you are lucky. But in case the rates are lower, your entire portfolio gets invested at a lower interest rate.
- This is what we call reinvestment risk.
- The arithmetic behind a bond ladder strategy is simple. Spreading out bond maturity dates, in fact, spreads out reinvestment risk.

BOND LADDERING

It is a lot like ‘not putting all your eggs in the same basket’. Likewise, your entire bond portfolio should not mature on the same date.



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Here's how…

The same logic would also apply to any other fixed income security, say, for instance, a certificate of deposit or even a bank's fixed deposit, all of which are subject to reinvestment risk.

But you should also keep in mind that spreading out your risk might also lower your overall return.

The simple truth is that when you gain something, you might also lose something.

The whole mechanism of bond laddering may require you to bear some kind of cost.

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What kind of cost?

For instance, bonds of different maturity in a bond ladder would earn different interest rates.

In a normal situation, bonds maturing early pay lower interest than bonds maturing at a later date.

So by investing your entire money into bonds of longer maturity you could get a higher rate of return.

BOND LADDERING

But despite the lower overall rate of return, the prospects of a bond ladder look bright.

As said, every year a part of your portfolio would be maturing, which means that every year you have an opportunity of making a new investment.

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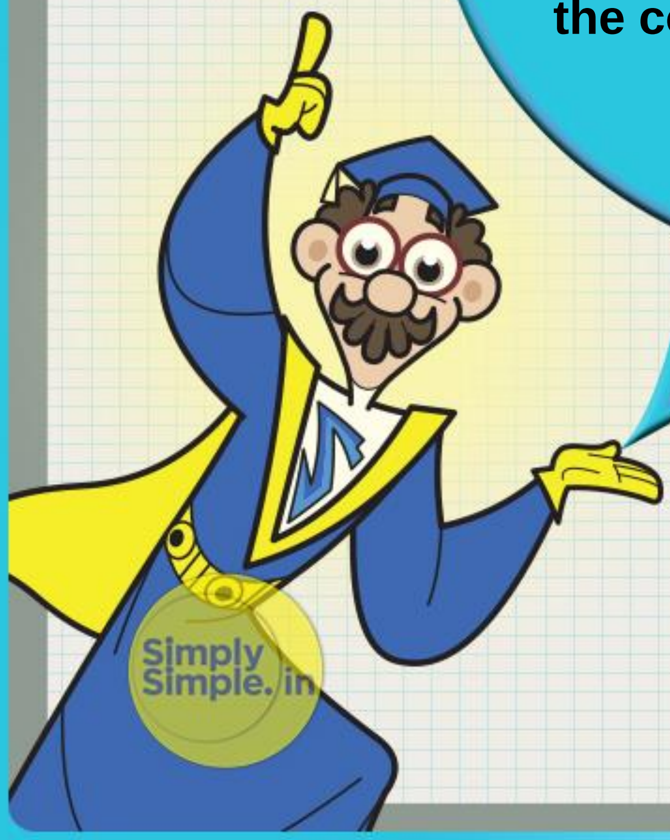
To Sum Up

- **What: Bond laddering is an investment strategy that tries to minimize the risk associated with the future movement in interest rates.**
- **How: A bond portfolio using laddering would consist of bonds having same face value maturing on different dates at a regular interval.**
- **Why: Bond laddering strategy is useful because it helps in minimizing the reinvestment risk.**

BOND LADDERING



Hope you have now understood

the concept of Bond Laddering

Thinking of Investment

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