

Should You Be Building Bond Ladders?

By [Joseph Lisanti](#) October 20, 2014, 4:18 p.m. EDT 6 Min Read



Bond ladders work well when rates are rising, giving wealthy investors sequential opportunities to exchange maturing low-rate debt instruments for higher-yielding paper. Rates are low now, but they will go up eventually — perhaps even next year, if the U.S. central bank starts nudging short-term rates higher, as many Fed watchers expect.

Yet predictions aside, do bond ladders make sense in this lower-rate environment? And if so, should advisors build the ladders or outsource the work to a fixed-income manager?

As with many strategies, laddering works best for clients with sufficient assets to benefit fully from it. “It is a tried-and-true strategy,” says Morris Armstrong of Armstrong Financial Strategies, an RIA in Danbury, Conn.

But even high-net-worth clients can't eliminate one of the major drawbacks to laddering now. "For me, it's preferable in a rising-rate environment," says Armstrong, noting that if you ladder two-, three- and four-year bonds today, rates are essentially flat. "In the old days, it was better."

But Armstrong says he still occasionally constructs bond ladders for clients. "I can't stay in cash at 10 basis points for two years," he observes. His solution is to use short-term fixed-income funds — because "1% is better than 10 basis points."

Erika Safran, founder of Safran Wealth Advisors in New York City, points out that laddering makes the most sense for clients with \$1 million or more in domestic fixed-income assets. With a client who may have only \$500,000 in assets, "it's not that easy to allocate 20% to 30% of that to a ladder portfolio," she says. "I can't reduce the credit risk by diversifying."

When laddering individual bonds, Armstrong says he sticks to single-A or better credit. That way, he says, if the bond rating is downgraded to BBB, you still hold investment-grade paper.

He also suggests buying carefully. "You should always look at two or three bids, if you can get them, for the same bond," he says.

PROFESSIONAL MANAGERS

An alternative to laddering is to let professional bond managers handle the fixed-income allocation — particularly if the active managers will do the laddering for you. Thornburg Investment Management, based in Santa Fe, N.M., for example, runs 11 fixed-income portfolios, nine of which employ laddering.

"We believe that the ladder portfolio is the best way to structure it," says Christopher Ryon, the Thornburg managing director who runs the firm's municipal bond offerings. Using a combination of Merrill Lynch muni bond indexes, Thornburg has tested laddering against barbell (long and short maturities) and bullet (concentrated intermediate maturities) approaches from 1997 through 2012.

Laddering doesn't always outperform the other strategies, Ryon admits, but "it works 70% of the time."

It's relatively easy for anyone to construct a ladder using Treasuries, he says. Before 2007, even munis were simple to ladder. But after the implosion of bond insurers during the financial crisis, spreads among higher- and lower-quality munis widened.

"Credit risk has become much more acute," says Ryon. He notes that professional bond managers watch not only credit, but also overall duration, curve exposure, convexity, sector allocation and security selection.

TARGET-MATURITY ETFs

For clients with limited assets, some advisors create ladders out of target-maturity ETFs, like Guggenheim's BulletShares and BlackRock's iBond series of AMT-free municipal bonds.

“The good news about them is that on a particular date the investor gets the money back,” Safran says. “I think they’re a relatively good investment as long as you know what to expect.”

Of course, that may take some explanation from the advisor. As managing director of product development at Guggenheim Investments, Bill Belden’s focus is on making sure his firm explains the subtleties of its nine investment-grade and seven high-yield target-maturity ETFs to financial intermediaries. Belden says the No. 1 client question is, “What am I going to get back at maturity?”

A simple answer to that may not be sufficient. Bonds in the ETF that were purchased at a premium and held to maturity will produce a loss when the client sells — and, Belden says, “The bulk of the bonds that are included in the funds have been acquired at premium prices.”

The upside, of course, is that the client has received a higher interest rate in the interim. Target-maturity ETFs are “a total return game,” Safran notes.

There’s another wrinkle. Although a target-maturity bond ETF is redeemed on a specific date, not all the bonds in the portfolio come due on that day. Some of the bonds mature earlier in the year — and how ETF managers invest those assets before the fund’s maturity can affect the return of the portfolio.

In some cases, bonds have longer maturities than the ETF, but are callable in the year the fund matures. If they are not called, the ETF’s managers must sell them before the portfolio shuts down. Whether the bonds sell at par, or above or below face value also will affect return.

For callable bonds that the issuer doesn’t plan to redeem before the ETF’s maturity, Belden says, Guggenheim sells at an opportune time. “We’re not waiting until the last business day of the year to sell the bonds off,” he says.

Guggenheim’s treatment of bonds that mature before the Dec. 31 termination of an ETF differs, depending on the quality of the paper. The proceeds from investment-grade bonds that mature in the first six months of the final year of a BulletShares ETF are reinvested in the fund’s remaining securities. After June 30 of the ETF’s maturity year, proceeds of investment-grade bonds go into cash equivalents, typically Treasuries. In the high-yield area, all proceeds from bonds that mature early are held in cash equivalents.

Advisors also have to deal with premiums and discounts on the funds themselves — common in the ETF space. “Use limit orders” when buying and selling the ETFs, Belden advises.

LADDER ALTERNATIVE

Some advisors skip ladder portfolios altogether. A. Raymond Benton, an advisor with Lincoln Financial Advisors in Denver, prefers to diversify across fixed-income product types, rather than over time periods, choosing assets not closely correlated to interest rates. Recently, his mix has been roughly 25% international, 25% high-yield, 25% high-quality and 25% short-term funds.

He notes that a big appeal of laddering is that investors don't have to look at the fluctuating value of their bond holdings. Such price movements don't matter to people who hold all the bonds to maturity — for example, for high-net-worth clients who have alternate sources of cash. But “most investors can't” do so, Benton says. “Most investors don't have unlimited assets and when they face unexpected expenses, they have to liquidate a bond.”

The bond market is far more opaque than the stock market. You can hire a fund manager to navigate for you, but there's a fee attached. Fees are lower for target-maturity ETFs that you can use to build a ladder, but watch the funds' total return carefully: Paying a premium for the ETF can be costly.

If your clients have enough assets, a ladder of individual bonds will help them escape the management fees they'd pay an active bond fund manager. Just understand that you'll still pay a spread to bond brokers and traders. As Safran notes, “There's no free lunch.”

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