US Private Wealth Management
U.S. Bank

Bonds play an important role in well-diversified portfolios

Investment Management

Owning bonds as a part of a well-diversified portfolio has often resulted in stronger long-term performance returns relative to the amount of risk incurred. For this reason, the investment strategists in U.S. Bank Private Wealth Management believe bonds can serve as a powerful diversifier due to their unique characteristics. However, not all bonds are created equal. Building portfolios to meet expected risk and return targets begins by selecting bonds with the appropriate attributes. In this paper, we outline some of the distinctions.

Traditional bonds are historically less volatile than stocks but have lower expected returns.

Corporations can raise capital by two primary means:

1. Borrowing money (in the form of taking out a loan or issuing bonds)
2. Selling rights to a portion of the business and the resulting claim on earnings (in the form of stock)

Stocks offer the potential for investors to own a growing or shrinking earnings stream, which results in high potential returns but a larger degree of risk. Bonds are structured to include a fixed-coupon payment, in addition to paying back the original principal amount. However, there is no guarantee that a bond will pay back the principal. In the case of corporate bonds, these payments must typically be made prior to distributing earnings to shareholders.

Interest rate risk and credit risk are the two most important sources of a bond's risk and return potential.

Bond risk can be broken down into numerous components, although two primary factors drive the majority of those risks:

1. The sensitivity to changes in interest rates (often referred to as **duration risk** or **interest rate risk**)
2. The willingness and ability of the issuer to make interest and principal payments (often referred to as **credit risk**)

Interest rate risk reflects bond price sensitivity to changes in market interest rates. When market interest rates rise, the price of a fixed coupon bond typically falls (and vice versa) since more attractive coupons are available in the open market. Bond cash

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 Important disclosures provided on page 4.

flows extending further in time result in greater price sensitivity, and shorter cash flows result in less price sensitivity. As a result, bonds with a longer maturity often have greater interest rate (duration) risk than bonds with shorter maturities. Importantly, price fluctuations that are only a result of interest rate sensitivity do not impact the likelihood a bond will be paid in full at maturity.

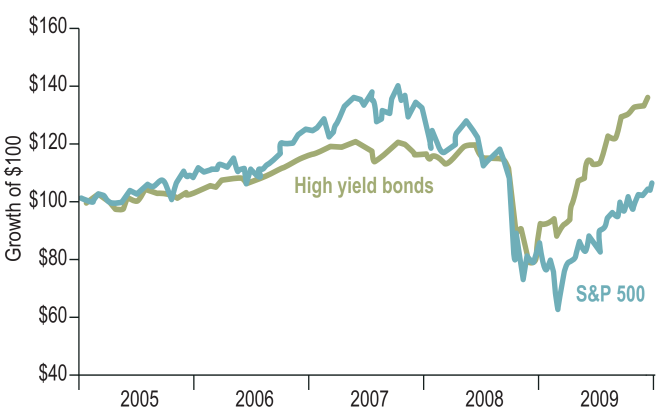
Credit risk reflects a bond issuer's willingness and ability to make principal and interest payments. As an example, U.S. Treasury bonds are perceived to possess near zero credit risk because the U.S. Treasury could theoretically print more money to repay debt if need be. Credit risk is often quantified by the difference a bond issuer must pay investors relative to U.S. Treasury bonds. For instance, investors would likely demand a much higher yield than U.S. Treasuries in order to buy bonds of a heavily indebted company with dim financial prospects.

Diversification against stocks

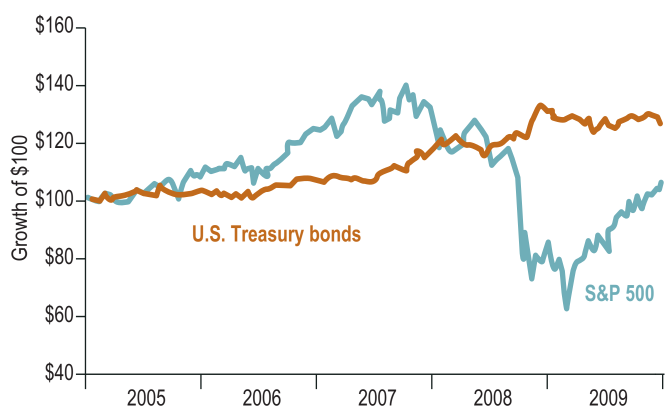
Bonds with limited credit risk, but a high degree of interest rate risk, often move differently than stocks, creating a powerful diversifying force within portfolios. This is due, in part, to investors seeking the safety of consistent, known coupon payments when stock prices are falling. It is also driven by the tendency for interest rates to rise (and bond prices to fall) when the economy is strong (and stocks are rising) and vice versa. Even in market environments in which stock and bond prices move in similar ways, the steady coupons from bonds can help stabilize the overall income generated by a portfolio.

Bonds with a high degree of credit risk often act similarly to stocks. Both stocks and bonds that have a high degree of credit risk typically do well when corporate sales are rising, profit margins are improving and investor optimism is growing. As a result of acting comparably, bonds with a great deal of credit risk contribute marginal diversification benefit to portfolios, despite sometimes offering compelling value.

During the financial crisis: Bonds rated below investment grade provided limited diversification benefits . . .



. . . while bonds with limited credit risk (such as Treasuries) provided strong diversification benefits

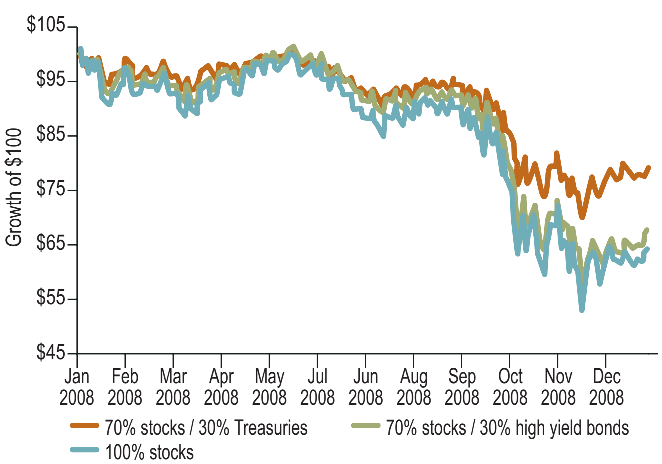


Source: U.S. Bank Asset Management Group, Bloomberg. Financial crisis data period reflects 1/03/2005-12/31/2009. Stocks represented by the S&P 500 Index. High yield bonds represented by Bloomberg Barclays U.S. High Yield Index. U.S. Treasury bonds represented by Bloomberg Barclays U.S. Treasury Bond Index. **Past performance is not a guarantee of future results**.

Avoid "putting all your eggs in one basket"

Ensuring a portfolio holds an appropriate amount of bonds that have limited credit risk may improve performance relative to the risk incurred. Diversification has historically reduced losses in challenging market environments by avoiding the classic mistake of "putting all your eggs in one basket." For certain investors, keeping a component of portfolios in bonds that have limited credit risk can provide an opportunity in weak market environments to buy stocks after they cheapen.

During the financial crisis: Portfolios diversified in bonds (with minimal credit risk) performed better than other portfolios



Source: U.S. Bank Asset Management Group, Bloomberg. Financial crisis data period reflects 1/02/2008-12/31/2008. Stocks represented by the S&P 500 Index. High yield bonds represented by Bloomberg Barclays U.S. High Yield Index. U.S. Treasury bonds represented by Bloomberg Barclays U.S. Treasury Bond Index. **Past performance is not a guarantee of future results**.

Conclusion

In our view, diversification remains a fundamental pillar of investing. In addition, bonds are often a necessary and contributing component of the overall portfolio construction process. Based on your investment goals, it's important to select bonds that have appropriate characteristics to help meet your portfolio's risk profile and other unique requirements. Please contact your advisor to discuss your situation and to learn more about the role bonds may be able to play in your investment portfolio.

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