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VOLUME 21 | EDITION 04

Richard P. Slaughter Associates Inc.
Darby Armont, MBA, CFP®, Vice President

"How should I assess and mitigate risks in my fixed-income portfolio?"

By Darby Armont

Stress is a part of life. Dealing with it in your fixed-income portfolio is crucial, not only for your peace of mind, but to ensure that your earnings continue to meet your financial goals and lifestyle needs.

A stress test is an evaluation by your portfolio manager of how your holdings would perform in various scenarios. Stress-testing is vital for volatile asset classes such as equities, but is equally important for a fixed-income portfolio. While bonds are usually viewed as a portfolio stabilizer, we must remember that significant fluctuations in price and yield can and do occur.

With fixed income, your money manager must consider how sudden or dramatic shifts or twists in the yield curve, changes in credit quality or currency instability may affect your portfolio. A careful and comprehensive analysis includes a variety of assumptions about issuer strength, interest rates, the yield curve, GDP, inflation, exchange rates and other economic factors.

There are three key risks to evaluate in a fixed-income portfolio:

Interest rate changes pose the most familiar threat. When rates rise, investors often flock to new issues with higher yields and sell lower-coupon offerings. This causes the price of these bonds to decline.

Yield curve twists or nonparallel shifts—in which the curve's slope flattens, steepens or changes in terms of the shape of the curvature—make up the most likely scenario. To mitigate this threat to fixed-income holdings, particularly when interest rates are expected to rise, a short-term duration is recommended. A portfolio also can be immunized against shifts by matching the duration of any needed future cash flow with the duration of the bonds.

Credit risk is the second area of concern for fixed-income portfolios. Most investors are familiar with analyzing the credit risk of corporate debt, but neglect to consider the credit risk of foreign sovereign bonds. Global market volatility must be taken into account, even when dealing with instruments from the most stable foreign governments. To assess potential credit risk, portfolio managers can model a recession or depression in a country or region and evaluate its expected stress on the issuing country's financial systems.

To mitigate sovereign credit risk, investors should avoid countries with weak economies, excessive government debt and deficits and unstable leadership. Exposure in risky areas should be limited and diversified.

Currency fluctuation goes hand-in-glove with foreign credit considerations as the third risk. When stress-testing portfolios for currency risk, managers must evaluate the relative strengths of currencies, the correlations among currencies, the economic climate of the currency zone, the size of the central bank's balance sheet and differences in inflation.

Many foreign bonds are denominated in dollars, allowing investors to avoid currency risk while gaining foreign exposure. Where bonds are issued in the home country's currency, investors can mitigate risk by purchasing instruments from countries with stable economies and sound fiscal and monetary policies.

Conscientious consideration: To mitigate the three types of risk, your fixed-income portfolio must have the appropriate duration, be invested in strong and stable companies and governments and have limited exposure to unstable currencies. A derivatives strategy using futures contracts and swaps can also be used to hedge exposures, although it does introduce counter-party risk.

Remember, however, that statistical models are only as good as the assumptions used to build them and may give false confidence to investors. So-called "black swan" events can occur, and this unexpected risk might not be adequately captured in a standard financial model.

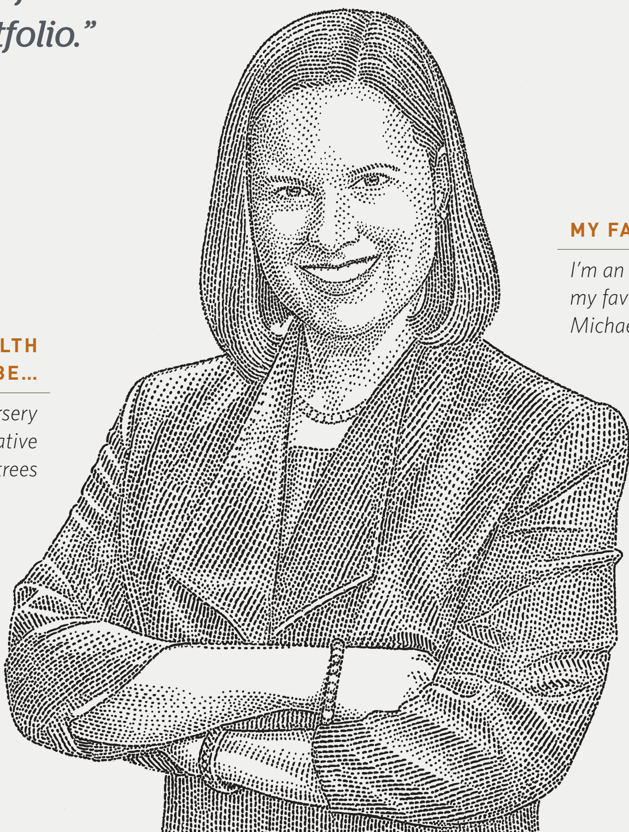
An exacting portfolio manager will work to provide a realistic outlook by conducting a meticulous review of your portfolio and its risks.

"Stress-testing is vital for volatile asset classes such as equities, but is equally important for a fixed-income portfolio."

—Darby Armont

How to reach Richard P. Slaughter Associates

You can reach any member of our team at 512.918.0000. *We look forward to speaking with you.*



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The owner of a nursery specializing in native plants and trees

MY FAVORITE AUTHORS...

I'm an avid mystery reader and my favorite authors are Lee Child, Michael Connelly and Laura Lippman.

WHAT MAKES A GOOD WEALTH ADVISOR...

The ability to communicate a complex financial plan in a meaningful and actionable way

About Richard P. Slaughter Associates

Richard P. Slaughter Associates is a leading wealth management and financial planning firm, which specializes in working with high net worth individuals, families and businesses. Slaughter Associates cultivates a comprehensive financial relationship with its clients by delivering expertise in financial planning and asset management and by coordinating with tax, insurance and estate professionals. The result is a holistic approach, unique in a financial industry that is often segmented and outsourced. By committing to each of these important components, Slaughter Associates charts a path to reach the individual financial goals of its clients. Founded in 1991 in Austin, TX, by Richard P. Slaughter, Slaughter Associates is one of the original fee-based firms in the nation. With offices in both Austin and the Dallas-Fort Worth Metroplex, Slaughter Associates has been recognized by the National Association of Board Certified Advisory Practices as a Premier Advisor and has been given Exemplary status for expertise in personal risk management.

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Largest Client Net Worth
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Minimum Fee for Initial Meeting
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Minimum Asset Requirement
$500,000 (investment services)

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Email darby@slaughterinvest.com

ILLUSTRATION BY KEVIN SPROULS

Richard P. Slaughter Associates Inc. | 13809 Research Blvd., Suite 905, Austin, TX 78750 | 512.918.0000

Darby Armont, MBA, CFP®
Vice President

Richard P. Slaughter Associates
13809 Research Blvd., Suite 905
Austin, TX 78750
Tel. 512.918.0000

darby@slaughterinvest.com
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