Principles of Individual Fixed-income Investing

There's more to bond investing than focusing on current interest rates. We believe it's important to understand how our investment principles — focus on quality, diversify and invest for the long term — relate to your investment decisions. Focusing on our three investment principles and keeping your strategy simple can help you work toward achieving reliable income, principal preservation and the ability to help reduce overall portfolio risk.

Keep It Simple

Before investing, you should discuss your goals with your Edward Jones advisor and determine an appropriate asset allocation. The two broadest asset classes are fixed income and equities.

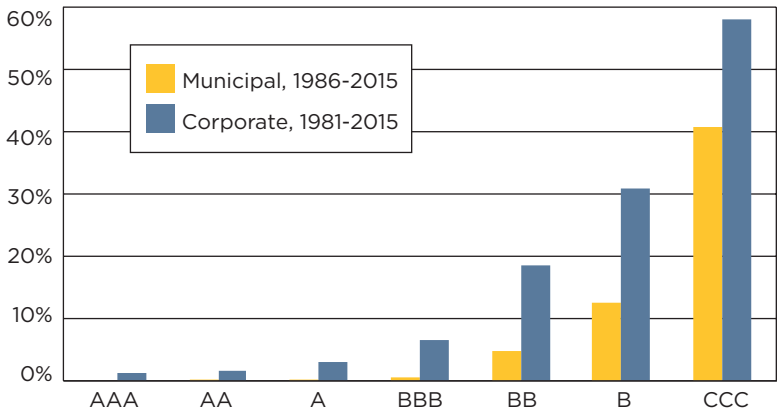
- Fixed-income investments include bonds, fixed annuities, preferred shares and Guaranteed Investment Certificates, which promise to make timely interest payments and return your principal upon maturity or redemption. We also include bond funds and bond exchange-traded funds (ETFs) in long-term fixed income. However, fixed-income investments may not keep pace with inflation.
- Equities include stocks and stock mutual funds that can offer potential rising income through dividend growth, helping combat inflation. However, historically, stocks fluctuate more, and the potential loss of principal is greater.

Equity and fixed-income prices tend to move in different directions over time, which can help smooth out your investment performance. That's why it's important to have the right balance between each in your portfolio.

Once you've determined the right asset allocation between equities and fixed income, think about how to invest your money. When it comes to fixed income, we recommend keeping it simple, by generally using the two major bond categories: government and corporate.

While preferred shares with investment grade credit ratings may play a useful role in your portfolio, we believe they aren't required to build an appropriately diversified portfolio. In fact, preferred shares should make up no more than 5% of your portfolio. Perpetual preferred shares are generally considered aggressive income due to their sensitivity to rising interest rates.

U.S. Cumulative Average Default Rates



Source: Standard & Poor's

Focus on Quality

Reliable income is an important goal of most bond investors. When you're buying bonds, don't be tempted by lower-quality bonds paying higher rates. Along with these higher rates come greater price volatility and the increased risk that these bonds will fail to make interest payments, as shown in the chart. Because of the lower default risk of higher-quality bonds, we recommend 85% of your portfolio comprise bonds and preferred shares rated AAA, AA or A. Although bonds with a BBB rating are investment-grade quality, they should make up only a small portion of your portfolio.

Edward Jones®
MAKING SENSE OF INVESTING

"Buy and hold" doesn't mean "buy and ignore" – Over the life of a fixed-income investment, credit ratings can change based on the issuer's outlook. If a bond is rated AAA, AA or A, it would still be investment grade with one or two downgrades. A downgrade from BBB to BB+ or lower means it's in the high-yield or "junk" category. The risk of failing to make timely interest and principal payments increases significantly when a bond is rated below investment grade.

If you have to sell a bond or preferred that has declined in credit quality, the market price may be significantly lower at time of sale. It's important to review your fixed-income investments periodically to make sure they still align with your goals and comfort level with risk.

GICs – Guaranteed Investment Certificates (GICs) are short-term savings investments issued by banks, trust companies and credit unions. Since GICs are insured up to $100,000 per depositor for each institution, they are of high credit quality up to the CDIC insurance limits. However, GICs must be held until maturity. They cannot be sold, redeemed or transferred from one account to another. This lack of liquidity reduces their overall attractiveness.

In addition, since GICs have short-term maturities, they are affected more by reinvestment risk. As a result, GICs may not be appropriate for the short-term portion of a fixed-income ladder. You don't need to own GICs as part of a well-diversified fixed-income portfolio. However, if you choose to own them, we suggest GICs make up no more than 15% of your fixed-income portfolio.

Diversify

You should strive to diversify your fixed-income investments. Some investors may benefit from owning broad-based bond funds or bond ETFs because they can offer diversification of credit risk. In addition, bond funds also offer the benefit of professional management.

As with any investment, there are trade-offs. Bond funds and bond ETFs don't offer a set maturity date or fixed rate of income because bonds are continually being bought and sold within the fund. Additionally, they don't offer a predictable income stream because their income will likely rise and fall with changes in interest rates. In fact, we generally recommend reinvesting any income from bond funds and bond ETFs when possible rather than depending upon that income.

If you want to invest in high-yield bonds, we believe it should be done through mutual funds or ETFs. Bond funds may be appropriate regardless of the amount you have to invest, but they're especially appropriate if your portfolio is too small to be adequately diversified owning individual bonds. If you prefer to own individual bonds, work toward ensuring that no more than 5% of your total portfolio be invested in any one issuer and that your portfolio is properly diversified as outlined below.

Diversify by issuer and sector – Owning bonds and preferred shares from a variety of types of issuers also can help reduce overall risk. We suggest a combination of government and corporate bonds, but some investors may also choose to add international fixed income. Quality corporate bonds usually pay higher interest rates than government bonds, reflecting their slightly higher risk, and as a result we suggest the following guidance:

	Sector Percentage of Fixed-income Holdings
Government	40% – 60%
Corporate – Financial	15% – 30%
Corporate – Industrial	10% – 25%
Corporate – Utility	5% – 15%

Government – Government bonds include Canadian federal government bonds, crown corporation bonds, provincial and municipal bonds, bonds of foreign governments and real-return bonds. Because these bonds tend to posess the highest credit quality, including them in your portfolio is a good way to enhance the overall quality of your fixed-income holdings. Historically, they've given investors relatively attractive returns on a risk-adjusted basis, especially when held in combination with equities. In addition, government bonds and real-return bonds are typically noncallable; therefore, they can help improve the overall call protection of your portfolio.

Corporate – Corporate bonds are categorized into three industry sectors: financial, industrial and utility. We recommend you own bonds from each category. That way, if a particular industry experiences some problems, you'll own other bonds that likely aren't affected by the same factors. For instance, if you primarily own financial bonds, we recommend you consider industrial or utility bonds, even if they offer a slightly lower rate. Review the recommended percentages above to help you better diversify the bonds in your portfolio.

The primary reason most people own bonds is for the income they provide and the promise of their principal being returned at maturity. A bond's interest rate shouldn't be the primary reason you purchase it. Even if bonds from a specific sector offer slightly higher rates than those of equal credit quality in other sectors, we believe you will most likely be better off buying a mix of bonds from a variety of sectors.

International – Exposure to international fixed-income investments may improve the diversification of your fixed-income portfolio. You may want to consider global bond funds that are widely diversified and primarily own developed-country bonds. However, they can add currency risk to your portfolio, making them typically more volatile than domestic investments. If they are appropriate for your situation, we recommend they make up no more than 5% of your portfolio.

In addition, you may choose to own U.S. dollar bonds, which offer attractive rates at times and include a wider variety of corporate issuers, which may improve the diversification of your bond portfolio. U.S. dollar bonds provide income to match any U.S. expenses you expect. While you don't need to own U.S. dollar bonds, the appropriate amount for you to own will depend upon your needs for U.S. dollar income and further diversification.

Invest for the Long Term

We recommend buying bonds with the intent of holding them until they mature or are called (redeemed) by the issuer. Unless the bond defaults, this can provide you with interest payments and the return of your principal upon maturity or call. Although some investors are tempted to jump into and out of the market as interest rates and bond prices change, we believe you should buy bonds for the current income they provide.

While the bond market generally fluctuates less than the stock market, both are similarly unpredictable. Don't try to predict interest rates. Instead, help manage your risk by owning a variety of bonds with different maturities. Commonly referred to as laddering, this means you invest an appropriate amount in short-, intermediate- and long-term bonds. Laddering can help balance the risk of price and income changes to smooth out wide swings in your income and principal. We recommend the following ranges when building your bond ladder:

	Percentages Based on Fixed-income Portion of a Portfolio
Short-term (up to 5 years)	25% – 35%
Intermediate-term (6–15 years)	40% – 50%
Long-term (16+ years)	20% – 30%

Start with short-term investments – Typically, beginning your ladder with bonds in the one- to five-year maturity range is appropriate. In that way, you will always have money coming due and can guard against the risk that the value of your investments will decline if interest rates rise. Then you can add intermediate- or long-term bonds as you have money available to complete your ladder over time. If you choose to own preferred shares, they should be included as part of the long-term portion of a ladder. Be sure that the securities held within the bond ladder are consistent with your investment objectives, risk tolerance and financial circumstances.

Watch the Call

Some bonds are "callable," meaning the issuer can call or redeem the bond before its actual maturity date. It's more difficult to ladder with callable bonds because you don't really know how long you'll own them. A bond with a call provision typically offers a slightly higher rate to compensate you for the risk of the bond being redeemed early. The risk of a bond being called can increase significantly if interest rates fall but is generally lower when interest rates rise.

This call feature benefits the issuer, who can refinance the bond at a lower rate. Callable bonds increase your reinvestment (or income) risk. This means that if a bond is called and interest rates are lower, as is typically the case, you'll have to reinvest your money at a lower rate.

You should try to limit the amount of bonds you own that are callable, when possible, and provide some variety
in the call dates of the callable bonds you own. In addition, noncallable and Canada yield call bonds* should be included in bond portfolios when appropriate to help diversify call risk.

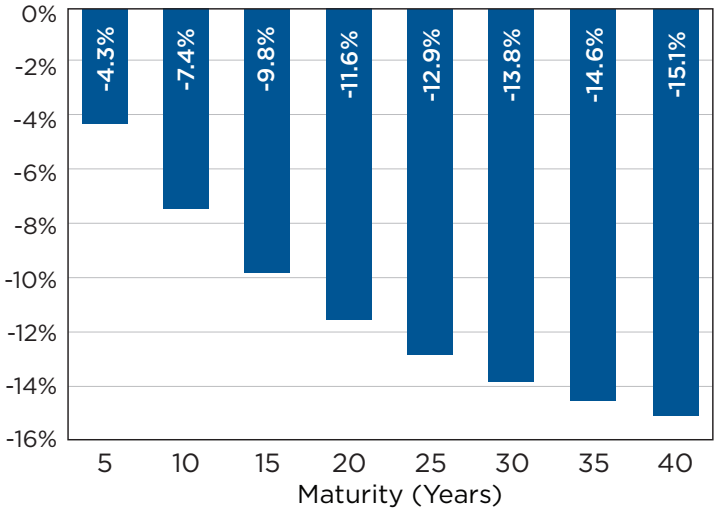
*A Canada yield call provision allows bonds to be called at any time, but issuers have to pay a higher premium to redeem bonds when interest rates are declining. It provides bondholders with compensation for missed interest payments due to the call. Since issuers aren't expected to redeem this type of bond, it provides better call protection for investors than typical callable bonds.

Bond Prices and Interest Rates

The income you receive from bonds is fixed, but the market value of a bond will vary over time, usually due to interest rate movements. Much like a teeter-totter, bond prices and interest rates move in opposite directions. The longer the maturity of a bond, the larger the move in bond prices when interest rates change. When interest rates rise, bond prices typically fall. The opposite is also true, although bonds that can be called by the issuer have limited opportunity to appreciate in price because the call price acts like a ceiling, keeping prices from rising.

If you own bonds, this relationship only affects the market value, or the approximate amount of money you would receive if you decided to sell an investment prior to the date it matures. The interest payments you receive are not affected. And if you hold the bond until maturity, you can still expect to receive the original face amount. However, preferred shares that are perpetual – meaning they have no set maturity date – will have the price sensitivity of very long term bonds since there is no timetable when principal will be returned. In addition, since preferred shares have an infinite maturity, unlike bonds, the price sensitivity will not decline over time.

Price Decline for a 1% Rise in Interest Rates for a 5% Coupon Bond



Source: Edward Jones calculations. This example is for illustration only and does not represent any currently available investments.

Please talk with your Edward Jones advisor about your individual fixed-income portfolio construction. He or she can recommend investments tailored to your portfolio objective.

If you're looking for current income, work with your Edward Jones advisor to determine which types and amounts of bonds are appropriate for you.

Diversification does not guarantee a profit or protect against loss.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently, and past performance may not be repeated.

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