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WSJ: Kerry Mayo, on the Benefits of Individual Bond Portfolios.

The biggest reason to use bond portfolios made up of individual bonds for your clients is that you can create something that is specific to the client. Bonds funds tend to be more generic and don't always work with clients' objectives.

But with individual bonds you can be more flexible, making sure clients' funds are there when they need them.

One thing to realize is that it's important to be working with client portfolios that are large enough to provide a good amount of diversification. For example, a bond portfolio less than $250,000 can't purchase enough different issues to provide that diversification.

What we've found is that as interest rates have declined, finding attractive yields is getting harder and harder. There's not a lot of yield available from regular corporate bonds, or regular tax-free municipal bonds–the common ones tend to trade more like commodities. So we think that we can create value for our clients by using bonds that are different than regular corporate or municipal bond bullet structures.

One of the things that we found a lot of value in is collateralized mortgage obligations, which are backed by cash flows from mortgages. When borrowers make their mortgage payments, they pay both principal and interest. So instead of getting the entire principal back at the end as with regular bonds, investors receive staggered payments depending on how the underlying loans were prepaid, either through refinancing or someone selling their home to move.

The CMOs are backed by mortgages, which can be insured against losses. Also a process called tranching means that junior, or subordinated class bondholders absorb any losses first. Understanding these factors allows you to choose which CMO is the best value for the client.

We've also found value in a specific kind of structured note called "steepener" notes, which base their coupon on the spread between interest rates of different maturities. There's also value in municipal bonds as long as you dig deeper to find what we call "story" bonds. These might look like bad investments on the surface, but when you dig into what the bond collateral is, they're actually a great value.

It's important that advisers do their homework and understand how to analyze all the factors that go into buying individual bonds. Having a good bond broker can also help. You need to understand the risks, so that if you're taking higher risk you're getting properly compensated with higher return.

Yields have been going down, but when they go up, the value of bond funds will fall. Investing in individual bonds can give clients some protection. In many ways it's a timing issue. The value of the bond portfolio isn't necessarily as important as the client's money being there when they need it. Even if a bond falls in value, individual bond portfolios can be structured so the client still gets the cash flows they need.

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Voices is an occasional column that allows wealth managers to address issues of interest to the advisory community. Kerry Mayo is a financial planner with Clifton Park, N.Y.-based Capital Financial Advisors of New York.

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