



BondNews

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Dear Hildy,

When age 70.5 is looming, Americans face a conundrum knowing that that they are required to begin taking distributions from their Individual Retirement Accounts (IRA). Should you decide to keep your IRA liquid in order to pay the approaching required distributions; or sell a bond, take the gain, and reinvest in a longer maturity bond paying a higher coupon? What are the factors involved in making the decision?

Please let us address your questions by asking [here](#).

Best regards,

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My IRA is Killing Me!! Or How to Think about IRA Investments and Distributions

Our client, let's call him Jim, is now 60 years old. He knows that under the current rules he will have to start taking distributions from his Individual Retirement Account (IRA) at age 70.5 years. Every year the distribution rate accelerates, but the required amounts are unclear because they change yearly. It is no surprise, that the distributions are based on complicated Internal Revenue Service (IRS) tables that induces an enshrouding fog in even the most sophisticated of investors. The unknowns in the accelerated rate of distribution was what made Jim shout: "My IRA is killing me!" He did not know how much he would be required to distribute. Considering years-to-maturity made him look into the abyss and contemplate his life span. It raised the question: "Do my bonds have to mature before I die?"

In September, 2010 the Treasury bond yield curve was very steep. This means that short-term returns were meager. Longer-term returns were attractive in comparison. Should Jim decide to keep his IRA liquid in order to pay the approaching required distributions or sell a bond to take the gain and reinvest in a longer maturity bond? Jim understands that if he trades in his short term zero-coupon Treasury bonds for a 20-year Build America Bond (BAB) he can increase his yield-to-maturity substantially.

This is the way we helped him to think about the transaction. He owned \$100,000 US Treasury Strips, paying no current interest, maturing on August 15, 2014 (a four-year bond that had a sale price of \$951 on September 3, 2010). The strips were originally purchased at a yield of 7.29 percent for a cost of \$290 per bond (\$29,000 total). Much of the gain in the bond came from the compounding of interest. However, if he were to purchase that same zero-coupon bond on August 15th, 2010 his yield to maturity would be only 1.5 percent. He decided to sell the bond and purchased Prince William County, VA Build America Bond (BAB) due 8/1/2030, with a call in 2020, a yield-to-call of 4.61% and a yield-to-maturity of 4.87 percent, an increase of 3.37 percent over keeping his US Treasury bonds to maturity.

What are the considerations in doing the trade? First, Jim knows that he will have to withdraw increasing amounts from his IRA. He questioned if he were to sell the short-term maturity and lock in a long term maturity, would there be enough cash to meet the withdrawal requirements? Jim discovered that if there was not enough cash, he could always move a security valued at the required withdrawal rate from his IRA account to a taxable account, or sell a security in his IRA and take a cash distribution. He decided that it was more important at this time to lock in the gain and increase his cash flow than to maintain the account liquidity.

A second consideration is the downgrade in the quality of the bond. Does it make sense to sell a triple-A rated Treasury (the highest possible rating) to purchase a lesser credit? Although Prince William County, VA bonds are rated the same as US Treasury bonds (Moody's Aaa rating), the risks are valued differently in the markets, and the triple-As are not considered equivalent. Jim decided that the top investment rating of this BAB was a good enough credit for his purposes.

A third consideration is the embedded assumption about interest rates. By selling Jim was betting that interest rates would either stay about the same or go lower for the foreseeable future. If they do rise, Jim is betting it will be a very slow increase in interest rates instead of galloping inflation. Remember, Jim's age and the age of the bonds move in an inverse relationship. In other words, the bonds' maturity gets shorter every year, just as Jim will get older. In a galloping inflation the value of the bonds will decline more sharply because of the longer maturity. In all cases the bonds will pay their face value at maturity.

Finally, the trade forced Jim to look at his mortality. "How long do I really have to live?" he had to ask himself. Will I die around the time that the bond matures? The answer is that nobody knows. We just live our lives until there is no more life to live. Jim did the trade. He did not want to earn 1.5% for the next four years, when he could he could lock in at least a 4.61 percent return. So instead of contemplating how soon before he might die, Jim decided to contemplate how wonderful it is to live. The higher return of the Build America Bonds compounded over time would protect his financial future.

Our philosophy has always been to seek out highly rated general obligation bonds, and bonds backed by revenue streams from essential services like water or sewer that generally carry the lowest risk of default. These are examples of what we call "plain vanilla" bonds in our bestselling book [Bonds: The Unbeaten Path to Secure Investment Growth](#), (Bloomberg Press, 2007).

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