

While many investors perceive bonds to be a safe haven, it is important to recognize that not all bonds are created equal. There are two primary sources of risk for bonds: 1) interest rate risk - the risk that rising interest rates will cause a bond's price to decline, and 2) credit risk - the risk that a bond issuer will fail to make interest and/or principal payments in a timely manner.

Interest rates and bond prices have an inverse relationship because investors compare the returns on their current investments to opportunities available elsewhere in the market. As market interest rates change, a bond's coupon rate, which is fixed, becomes more or less attractive to investors who are, therefore, willing to pay more or less for that bond. For example, suppose a company offers a new issue of bonds carrying a 5% coupon, and a year later interest rates go up so that comparable new bonds pay a 6% coupon. Bond investors would be unwilling to pay full or "par" value for the 5% coupon bond. They would demand a discount, sufficient to enable them to earn approximately 6% from the lower-coupon bond.

With short-term bonds, interest rate risk is less significant because rates are unlikely to change substantially in a short period. Short-term bonds are also easier to hold until maturity, thereby alleviating an investor's concern about the effect of interest rate changes on the price of bonds. Over the past two years, interest rates have fallen to historic lows, with the two-year U.S. Treasury note now yielding just 0.60%. When inflation mounts, interest rates usually increase with it. Inflation is currently hovering around 2%. While the Federal Reserve has yet to indicate that they plan to raise interest rates in the near future, the market will eventually anticipate any increase in rates, resulting in lower bond prices.

In today's low interest rate environment, it is tempting to seek out higher-yielding investments. It is important to understand, however, that in order to garner higher yields in the bond market, one must, without exception, assume greater risk. Increased risk for bonds can come in the form of either longer maturities (a 30-year bond yields more than a 5-year bond) or lower credit quality (a lower quality bond yields more than a higher quality bond). Higher risk means greater volatility and a higher probability of negative returns. The riskiest, highest-yielding bonds demonstrate stock-like characteristics. For example, the Loomis Sayles Bond Fund, which holds longer-term, lower-quality bonds declined over 21% in 2008 before rebounding by over 37% in 2009. In contrast, Vanguard Short-Term Bond Index Fund, which invests in high-quality short-term government bonds, rose 5.4% in 2008 and 4.2% in 2009.

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We continue to position the bond portion of client portfolios in “safer,” shorter-term, higher-quality securities to offset the risks of holding stocks. While it is frustrating to accept the current low interest rates, doing so will help avoid future disappointment and keep money available for higher rates in the event general rates increase. The most successful investors are those that resist overreacting to current events by changing the structure of their portfolios. As always, we invite you to contact us with any questions or concerns.

To accommodate our continued growth, we are pleased to announce that Dowling & Yahnke will be moving into larger office space at the end of August. We will remain in our present building but will be doing business on the fourth floor. You will receive a postcard reminder as the date approaches. We look forward to welcoming you to our new office.

We have enclosed our Privacy Statement, which we provide to our clients on an annual basis in accordance with Securities and Exchange Commission regulations. We appreciate your trust and confidence in Dowling & Yahnke. Have a wonderful summer!

Sincerely,

DOWLING & YAHNKE, LLC