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The Financial Planning Newsletter

How Can I Tell Whether It Is a Good Time to Refinance My Mortgage? It may be worthwhile to refinance if you can lower your monthly payment by a significant margin and you plan to stay in your home long enough to recoup the cost of refinancing.

To Refinance or Not Consider this example: If you had a $200,000, 30-year mortgage with 7% interest rate, your monthly payment would be about $1,330 (not including property taxes and insurance). If you refinanced at 6%, your new monthly payment would be $1,199, a savings of $131 per month. Assuming your new closing costs amounted to $2,000, it would take 16 months to break even ($2,000/$131=15.27, so we round-up to 16). If you planned to stay in your home for at least 16 more months, then a refinancing would be appropriate under these conditions. If you planned to sell the house before then, you might not want to bother refinancing. Or, you might find a lender offering lower closing costs.

All Mortgages Are Not Created Equal When considering whether to refinance, don't choose a mortgage based only on its stated annual percentage rate (APR), because there are many other important variables to consider.

- The term of the mortgage: Shorter terms can result in significantly reduced interest costs over time. On the other hand, they will almost certainly require higher monthly payments.
- The variability of the interest rate: An adjustable rate may be lower initially when compared with a fixed rate, but adjustable rates are likely to move upward over time. With a fixed rate, there is certainty regarding your monthly principal and interest payment over the life of the mortgage.
- Points: Also known as origination fees, points are paid to a lender or mortgage broker at closing. One point usually equals one percent of the loan's value. Mortgages described as "no-cost" or "zero points" do not carry this upfront cost but may charge a higher interest rate, which may add to the long-term cost of the loan.
- Other mortgage-related fees: When you refinance, you may pay a mortgage broker fee (assuming you do not go directly to a bank or other lender), a title insurance premium, a commitment fee, attorney or settlement fees, an appraisal fee, and other costs that can add up quickly.

The amount of money you may save and how long you plan to live in your home are the key variables that influence whether you should refinance your mortgage.

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How Much Could You Save by Refinancing?

A homeowner with a 30-year, $200,000 mortgage charging 7% interest would pay $1,330 each month. This table below illustrates the potential monthly savings and the various break-even periods (assuming $2,000 in closing costs) that would result from refinancing at different rates.

*Rates for 30 year, fixed rate loans recently averaged just below 4%. As for 3.5%, we can hope can't we?

Rate After Refinancing	New Monthly Payment	Monthly Savings	Months to Breakeven
6.0%	**$1,199**	**$131**	**16**
5.5%	**$1,136**	**$194**	**11**
5.0%	**$1,074**	**$256**	**8**
4.5%	**$1,013**	**$317**	**7**
4.0%*	**$954**	**$375**	**6**
3.5%*	**$898**	**$432**	**5**

Understanding and Managing Risk in a Bond Portfolio Bonds and bond mutual funds offer one way to add diversification to long-term investment portfolios and may help generate a steady stream of income. But even fixed-income investments, generally considered less volatile than stocks pose an element of risk. Understanding the different types of risks can help you manage your portfolio's downside exposure and enhance your potential for income.

Diversification and Income Generally, there are two reasons for considering investments in bonds: diversification and income. Bond performance does not typically move in tandem with stock performance. For example, a downturn in the stock market may be offset by an increase in demand for bonds. As many investors learned (re-learned, actually) in 2008 and again in the summer of 2010, when crises strike, the money belonging to many investors heads for US government bonds.

Some investors view the bond market as a safer haven for their money during periods of stock market uncertainty. While corporate bonds may have higher returns than their government counterparts, corporate bonds may actually weaken in price as the perceived strength of the underlying corporation is questioned by equity investors.

Bonds also offer the potential for higher income than more conservative investments like money market mutual funds. Typically, US government bonds pay less interest than a corporate bond. Municipal bonds tend to have interest rates in between. Additionally, there are very high yielding corporate bonds (often referred to as “junk bonds”) issued by distressed corporations, or by companies in weak economic areas.

Essentially, a bond represents a loan to a corporation, municipality, or government agency. For lending them money, bond issuers promise to pay the bondholder a specific amount of interest, usually quarterly or semiannually, and repay the full amount of principal on the maturity date. The level of income potential depends on several factors, including the type of bond and tax classification. In addition to the potential rewards, bond investors should be aware of the risks, including credit, market, interest rate, reinvestment, and call risk.

Understanding the Risks Credit risk refers to the possibility that a bond issuer will default on a payment before a bond reaches maturity. To help investors make informed decisions, independent firms such as Moody's Investors Service and Standard & Poor's publish credit-quality ratings for thousands of bonds. The upside of a poor rating is greater reward potential. Issuers of lower-rated bonds usually reward investors with higher yield potential for accepting the relatively greater risks. As a rule of thumb, bonds issued by corporations or municipalities with a triple-B rating or higher are called investment-grade bonds. Non-investment-grade bonds, with ratings as low as D, are sometimes referred to as junk or high-yield bonds because of the higher interest rates they must pay to attract investors.

If an investor is unable to hold an individual bond through maturity, when full principal becomes due, market risk comes into play. If a bond's price has fallen since acquisition, the investor will lose part of his or her principal at sale. To help mitigate exposure to market risk, investors should evaluate their overall cash flow projections and fixed expenses between the time they plan to purchase a bond and its maturity date. Basically, market risk means you have to take whatever price the market is offering for your bond if it is to be sold before it matures.

Bond prices tend to drop when interest rates rise, and vice versa. This inverse relationship is referred to as interest rate risk, which may be a particular concern to investors who don't plan to hold a bond to maturity. A premature sale while rates are rising could result in a loss of principal. Exposure to interest rate risk increases with the length of a bond's maturity. Issuers generally pay higher yields on longer-term bonds than on those with shorter maturities.

A low interest rate environment also exposes bondholders to call risk, the right of an issuer to redeem a bond before its stated maturity. Issuers typically call bonds when interest rates drop, allowing them to pay off higher-cost debt and issue new bonds at a lower rate. Bonds paying higher yields are most susceptible to call risk. Changes in interest rates also may give rise to reinvestment risk, the chance an investor may not be able to reinvest either the income from a bond or the proceeds at maturity at the same level of return and risk.

Inflation risk is the danger that the income produced by a bond investment will fall short of the current rate of inflation. (For example, if your fixed-income investment is yielding 3% during a period of 4% inflation, your income is not keeping pace.) The comparatively low returns of high-quality bonds such as U.S. government securities are particularly susceptible to inflation risk.

Risk Management Options To counter the risk of inflation, individuals can purchase inflation-protected government securities and bonds convertible into stock. Inflation-protected securities include 10-year Treasury notes whose redemption value is subject to adjustment every six months based on changes in the Consumer Price Index. Because of the inflation-protection feature, the interest paid on the notes is likely to be less than that paid on fixed-rate 10-year Treasury notes issued at the same time.

Convertible bonds offer the holder the potential option to exchange the bond for a specified number of shares of the company's common stock. In return for the ability to share in possible appreciation of its stock, the bond issuer offers a lower rate than those available on nonconvertible bonds.

Other risk management approaches are more likely to suit investors with substantial income-producing assets. Laddering is one such strategy to help smooth out the effects of interest rate fluctuations. "Laddering" involves setting up a portfolio of bonds with varying maturity dates ranging from shorter to longer term. For example, you might purchase equal amounts of Treasury issues maturing in one, three, five, seven, and nine years, giving you an average maturity of five years. As the principal comes due every two years, you would reinvest that amount in Treasuries due to mature in 10 years, preserving the five-year average maturity. Such a rolling portfolio not only helps to limit reinvestment risk, its staggered maturities provide liquidity at specific intervals without having to sell into the market.

Another strategy is to construct a "barbell" in which a portfolio is invested primarily in short- and long-term bonds with few intermediate maturities. In theory, the barbell structure allows the longer-term portion of the portfolio to take advantage of higher yields while the shorter-term portion limits risk.

Alternatives to Consider In addition to maintaining a diversified portfolio, investors may want to consider insured bonds, typically municipal bonds whose issuer has bought insurance to pay off bondholders in the event of default. Similarly, investors can manage call risk by knowing each bond's first call date and avoiding bonds with call dates in the near future, especially if interest rates are falling.

Of course, not everyone has the time or knowledge to manage a portfolio of individual bonds. With so many bond options to choose from: Treasury, federal agency, municipal, corporate, and mortgage, among them, and with individual bonds requiring initial investments ranging from $1,000 to more than $25,000, many investors opt for the ease of bond mutual funds. Bond mutual funds offer instant diversification, professional management, and daily liquidity. However, bond funds may also trigger taxable events, without your prior knowledge. Often people ask what's the difference between a bond and a bond fund. Well, the single most important difference is that a bond has a maturity date with a known price at maturity, while a bond fund does not have either of those.

The bond market provides a wealth of fixed-income products to suit virtually every investment goal and risk level. Online resources such as the Bond Market Association's web site (www.investinginbonds.com) can aid research. Still, choosing bond investments addressing your specific financial needs often isn't easy. For example, check out the website for the governance group overseeing municipal bonds, the Municipal Securities Rulemaking Board, www.msrb.org.

Points to Remember

1. Understanding bond risks can help investors limit the downside exposure of their portfolio and increase its income potential. As with equity investments, there are many varieties of bonds and diversification is critical.
2. Bonds expose investors to various types of risk, including: credit, market, interest rate, reinvestment, inflation, and call risk.
3. To compensate for their higher risk, bonds with lower credit quality ratings generally pay investors higher interest rates than bonds with higher ratings. Also because of their greater risk, longer-term bonds typically pay higher rates than bonds with shorter maturities.
4. Laddering, the barbell approach, and diversification are among the risk management strategies used for larger fixed-income portfolios.
5. The diversification, professional management, and daily liquidity of bond mutual funds make them suitable for many investors.

Banks Have New Target for Fees: Debit Cards A number of major financial institutions are testing or implementing new programs that will levy monthly fees on consumers who use their debit cards.

A number of major financial institutions, including Wells Fargo and JP Morgan Chase, are testing or implementing new programs that will levy monthly fees on consumers who use their debit cards.

The banks are trying to recoup revenues lost when the Dodd-Frank Wall Street Reform and Consumer Protection Act took effect in 2010. The new regulation capped overdraft fees and charges banks could assess to credit card customers. The banking industry reportedly will lose about $6.6 billion in fees due to the new limits on "swipe fees." Don't worry, with these new fees, the banks will quickly recoup more than $5 billion of these "lost" fees.

The new fees are assessed when consumers use their debit cards for purchases (non-ATM type transactions). The fees reportedly will range from $3 to $5 per month, depending on the bank.

- Bank of America reported in September 2011, in early 2012 it will begin charging customers $5 per month for debit card usage at non-ATMs.
- Wells Fargo will begin testing its $3 monthly charge in October for customers in five states: Georgia, Nevada, New Mexico, Oregon, and Washington. Wells Fargo will also eliminate its debit card rewards program effective in October.
- Regions Bank will institute an across-the-board debit fee of $4 per month on certain accounts beginning in October.
- Earlier this summer, SunTrust started levying $5 per month fee to its Everyday Checking account holders.

Consumers Beware Many industry experts expect more banks to launch fees on debit cards in the coming years. Pay attention to what your financial institution sends you in the mail, both separately and with your statements. If you have questions, call your bank for an explanation.

If your bank has already sent you a communication signaling that changes are on the way, you do have one very valuable option: shop around. While many larger banks may be tempted to charge a fee for debit card usage, some smaller banks and credit unions (they are supposed to be not-for-profit) probably won't follow suit. You can always move your account to another institution still offering free services. However, if you have multiple accounts with one institution or don't have any other banks near you, this may not be the most practical or convenient option.

Also, be sure to review your bank's new terms carefully. You may satisfy certain requirements to keep your services free or you may be able to switch to a different type of account to avoid any charges.