REALITIES OF INCOME INVESTING

Understanding interest rate and credit risks // Evaluating your portfolio // Taking action

KEY TAKEAWAYS

Although rising interest rates may provide an opportunity for increasing income, the value of many fixed income investments may decline as rates begin to rise.

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Credit quality of bond holdings within portfolios should be assessed to determine if they remain aligned with your risk tolerance and investment objectives.

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Investors should work with their financial advisor to analyze the fixed income investments in their portfolio, re-evaluate the role they play in their overall financial plan and consider strategies available to manage risks.

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INTRODUCTION

Income-producing investments traditionally play a very important role in investors' portfolios. Just like every other aspect of a well-maintained investment plan, these investments should be reviewed regularly to ensure they are still appropriate given ever-changing circumstances. Markets today are presenting investors with challenges that should be considered when evaluating fixed income investments, most predominantly interest rate and credit risks. In this paper, we'll examine these risks and investment strategies to prepare you for a discussion with your financial advisor.

Now may be a good time for investors to revisit what they own – and why. Do you own individual bonds, bond mutual funds, exchange-traded funds or other managed products? Do you own them to generate income, to mitigate equity risk, or for preservation of capital? While traditionally serving as the bedrock of a portfolio, bonds are generally subject to price declines in a rising interest rate environment and the answers to these questions will impact the steps you should take to prepare for a shifting market backdrop.

RECENT HISTORY

Bonds have enjoyed a multi-decade rally since the early 1980s, when interest rates began their long, steady decline from all-time highs to historic lows. With interest rates near historic lows and the Federal Reserve gearing up for a potential increase in short-term rates, it is unlikely that returns can persist at these levels.

U.S. Treasury Yield

*The Barclays U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance. Holding bonds to maturity allows redemption at par value. However, if bonds are sold prior to maturity, proceeds may be more or less than your initial investment.

STRETCHING FOR YIELD As interest rates declined toward record lows, many investors may have taken on additional risks in their portfolios to generate higher yields by investing in lower credit, longer-duration bonds, or other yield-producing investments. To avoid unwanted levels of risk, investors should work with their financial advisor to review their portfolio and make changes as needed. Your advisor can help you choose appropriate income vehicles to diversify your portfolio and manage risks while attempting to capture higher yields. While a diversified mix of income holdings doesn't necessarily guarantee against a loss, it can provide additional income sources as well as greater total return potential.

KNOW WHAT YOU OWN

The first step to managing risks in your portfolio is to make sure you understand what you own.

When investing in bonds, you have several options, including individual bonds, bond mutual funds, closed-end funds, exchange-traded funds (ETFs), and separately managed accounts (SMAs). Each of these have different characteristics and risk profiles so it is important to understand how each will be impacted by changing market factors and how that will affect your bond portfolio.

Individual bonds have long been the traditional option for fixed income, but for investors with smaller account sizes, bond mutual funds and closed-end funds have become a popular choice for diversification and professional money management. Bonds may also be purchased as part of an SMA, through which portfolio managers have discretion over security selection. Below is a comparison of these investment vehicles.

INVESTMENT CONSIDERATION	INDIVIDUAL BONDS	PACKAGED PRODUCTS (Bond Funds, Closed-End Funds and ETFs)
Knowing what you own	Investor knows exactly what bond is bought, its credit rating, coupon rate and maturity date. 100% of the money is invested, earning interest and full principal is returned at maturity given the creditworthiness of the issuer.	**Bond mutual funds and closed-end funds:** Investor knows the main objective of the fund (e.g., intermediate-term corporate bond fund), however the portfolio manager may not always adhere – known as "style drift." By prospectus, many mutual funds provide a set percentage of a fund that s not required to be invested in the primary strategy. As an example, an intermediate-term corporate bond fund may own 10% in short-term corporate bonds, at any given time. Information is available to shareholders from funds periodically detailing the holdings in the portfolio. In addition, bond funds are not always fully invested, holding cash for administrative needs and redemptions. **ETFs:** Offer complete transparency and intraday pricing and trading.
Income	Offer predictable income stream known at the time of purchase.	**Bond mutual funds:** Typically pay monthly coupon payments based on the security type and the amount of cash held in the portfolio. **Closed-end funds:** Payments vary based on investments and cash held in the portfolio (though typically fully invested) and current market rates. **ETFs:** Traditional, index-tracking ETFs provide income similar to the securities that comprise the index.
Principal protection	The amount of principal (i.e., par value) that will be returned at maturity is known at the time of purchase subject to credit worthiness of the issuer.	Since bond mutual funds, closed-end funds, and ETFs do not mature at a set date and pricing fluctuates daily, it is impossible to predict the value of an original investment at the time of sale.
Diversification	Many bonds are needed to achieve proper diversification. Remember: do not put all of your eggs in one basket.	Greater diversification is achieved through a large number of holdings, facilitated by many investors.
Liquidity	Can be liquidated at current value less a sales commission, depending on account type. The amount received may be more or less than original cost.	**Bond mutual funds:** Can be sold at net-asset-value at the end of the trading day, which may be more or less than original cost. **Closed-end funds:** Sold at market price. Market prices fluctuate based on supply and demand and typically trade above (premium) or below (discount) the fund's net asset value. **ETFs:** Sold at market value with intraday trading flexibility.
Costs	Either a one-time commission or an annual management fee if held in an SMA with low individual transaction charges paid at the time of purchase or sale.	Either a commission or fee applies, depending on account type. Additionally, the funds will have internal expenses.
Capital gains taxes	Generally paid only if a bond is sold for profit prior to maturity date.	Paid if shares are sold for a profit or when bonds are sold within the portfolio for a profit. Investors may also be liable for tax on imbedded gains, even if they have not enjoyed the returns. **ETFs:** Enjoy minimal capital gains due to the share creation/redemption process.

Diversification does not guarantee a profit or protect against loss. Passively managed ETFs represent an unmanaged index of securities. Closed-end funds, ETFs and other products that use leverage can increase potential losses.

KNOW WHY YOU OWN IT

The next step to managing risks in your portfolio is to reaffirm **why** you own specific investments. Investors typically include income-producing investments in their portfolios for a variety of reasons:

- Predictable income
- Diversification from equities
- Preservation of capital
- Total return opportunities

Depending on the specific role these investments play in your portfolio, the associated risk factors will have a different impact on your decision-making process. Ask yourself why you own bonds.

Other factors can also impact your bond allocation, including your investment time horizon, risk tolerance and future goals, but the "why" is critical to beginning to work with your financial advisor to determine action steps.

Asset allocation and diversification do not guarantee a profit nor protect against loss.

Ask yourself why you own bonds ?

Are they are part of an overall asset allocation?

Are they needed for income?

Are they a temporary parking place for investment funds as an alternative to low-yielding cash?

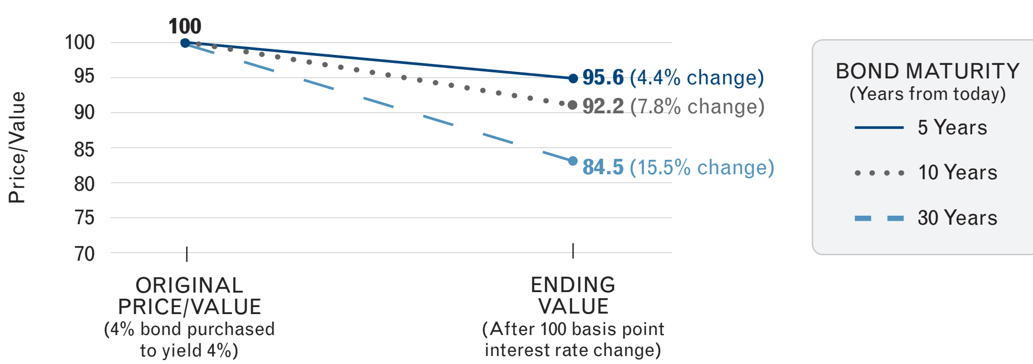
UNDERSTANDING TODAY'S RISKS

INTEREST RATE RISK

As economic conditions continue to improve, interest rates are likely to rise and investors may have reason to be concerned about potential declines in the value of their income producing-investments. Remember, as interest rates rise, bond prices typically decline and vice versa.

The following illustrates how a bond's value is reduced when interest rates rise. Conversely, the value would increase when rates fall. This example assumes a 4% coupon bond with a 4% yield at inception (priced at par: 100.0). If the market rate for like bonds went up to 5% (a 100 basis point change), the value of the bond would decline by the amount shown.

SENSITIVITY IN BOND PRICE TO CHANGES IN INTEREST RATES



Note these are examples and approximations. This example assumes non-callable bonds. Callable bonds have different sensitivities when they are priced above 100.0.

*A basis point is 1/100 of 1%. A 100 basis point change would be when interest rates move 1 full percent, for example moving from 4% to 5%. The change in value shown is specific to a 100 basis point rate change in similar securities. If the rate change was only 50 basis points, (or a 1/2% rate change), the value change would be roughly half of what is shown. By extension, if the rate change was 300 basis points, the change in value would be approximately 3 times what is shown.

Many investors, however, own individual bonds to receive steady, consistent income. Since these income-focused investors typically hold bonds to maturity when the par value is returned, subject to the creditworthiness of the issuer and/or a call at the issuer's option, they may not be as concerned about changes in the value of their bonds due to movements in interest rates. If investors do not need the income, and are instead using bonds to achieve an attractive total return, they may be more sensitive to losses and take other actions. This is why it is so important to work with your financial advisor to understand the role income-producing investments play in your portfolio.

Remember, as interest rates rise, bond prices typically decline and vice versa.

FINRA WARNING TO INVESTORS

The Financial Industry Regulatory Authority (FINRA) is a private, non-governmental agency that regulates its member brokerage firms and the financial markets. Its mission is to protect America's investors by ensuring the securities industry operates fairly and honestly. As part of this effort, FINRA regularly issues explanations on how current market conditions may impact investors. The following excerpt is from a commentary on the impact of rising interest rates on fixed income investors:

"Currently, interest rates are hovering near historic lows. Many economists believe that interest rates are not likely to get much lower and will eventually rise. If that is true, then outstanding bonds, particularly those with a low interest rate and high duration, may experience significant price drops as interest rates rise along the way. Investors who have money in a bond fund that holds primarily long-term bonds can expect the value of that fund to decline, perhaps significantly, when interest rates rise." (02/14/13)

What is duration?

In simple terms, modified duration gives an idea of how the price of a bond will be affected should interest rates change. A higher duration implies greater price sensitivity to changes in interest rates. Duration is quoted as the percentage change in price for each given percent change in interest rates. For example, the price of a bond with duration of two would be expected to decline by about 2% for each 1% move up in rates. On the other hand, the price of a bond with duration of 10 would be expected to decline 10% for the same 1% increase in rates.

The duration of a bond is primarily affected by its coupon rate, yield and remaining time to maturity. If all else remains equal, a bond's duration will increase as:

- Time to maturity increases
- Coupon rate decreases
- Yield decreases

The effective duration of callable bonds trading at a premium may increase considerably if they begin trading at a discount.

CREDIT RISK

The safety of your principal depends on the issuer's credit quality and ability to meet its financial obligations, such as payment of coupon and repayment of principal at maturity. Credit agencies assign ratings based on their analysis of the issuer's financial condition, economic and debt characteristics, and specific revenue sources securing the bond. Issuers with lower credit ratings usually offer higher yields to compensate for the additional credit risk.

It is important to note that credit risk isn't limited to an issuer declaring bankruptcy or missing a payment. A change in either the issuer's credit rating or the market's perception of the issuer's future prospects can affect the value of its outstanding securities and investors can see their bonds decline in price. Ratings are not a recommendation to buy, sell or hold, and may be subject to review, revision, suspension or reduction, and may be withdrawn at any time.

Another potential concern is if fund managers increase credit risk beyond the objective in an attempt to generate greater yield. This can happen the same way investors "stretch for yield" in their portfolios. It's important to be aware of the credit quality of the fund's holdings. Investors should be aware of and monitor the crediworthiness regularly with their financial advisor.

ADDITIONAL CONSIDERATIONS

There are numerous other risks that you should be aware of when investing in securities designed to provide income.

Purchasing power risk:
Over time inflation may lower the value of returned principal. This means an investor will be able to purchase less with the proceeds received at maturity. Higher inflationary pressures usually result in higher interest rates.

Reinvestment risk:
Those who lock in their returns by investing in long-term bonds might not be able to reinvest at higher rates when rates go up. However, those who buy short-term securities or callable securities may face the risk of having to reinvest at lower rates when interest rates drop.

Foreign bonds:
Additional risks include, without limitation, liquidity, currency fluctuations, differing accounting standards, political and economic instability, and differing tax laws.

High-yield bonds:
Not suitable for all investors. The risk of default may increase due to changes in the issuer's credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of a portfolio.

Municipal bonds

The extended economic slump has negatively impacted many municipalities' core revenues including nearly across-the-board decreases in their income tax, sales tax, property tax and other revenues. At the same time, expenses and other financial obligations (such as pension obligations) have been difficult to reduce creating concerns about the ability of some municipal bond issuers to satisfy their debt obligations. The major rating agencies that evaluate the credit quality of municipal issuers and their bonds - Moody's, Standard & Poor's and Fitch - have issued rating downgrades on some municipal securities.

However, highly rated municipal issuers have historically demonstrated excellent financial strength and defaults and bankruptcy are a very rare occurrence. They're generally considered second only to U.S. Treasury securities with respect to consistently satisfying their debt obligations.

The municipal bond market is highly diverse, consisting of more than 50,000 different issuers. Many bonds are susceptible to these areas of concern, but many others will be less affected. Credit strength and resiliency vary a great deal from bond to bond. We believe the diversity of the municipal market offers investors many choices, with plenty of options to help navigate today's environment.

TAKING ACTION TO MANAGE RISKS

The steps you take to manage fixed income risks in your portfolio depend on your individual circumstances, most notably what you own and why you own it. You should work closely with your financial advisor to discuss your situation and make informed decisions based on thoughtful analysis.

Step 1: Reaffirm why you own fixed income and your risk tolerance

Start by confirming why you own fixed income investments, the role they play as a part of your overall asset allocation and evaluate your risk tolerance in view of the risks that may be present going forward.

Certain risks will impact you differently depending on your objectives and the types of investments you own. As we mentioned earlier, if you own bonds to receive consistent income, you may plan to hold your individual bonds to maturity for full return of the par value. In this scenario, you may not be overly concerned about price fluctuations in the value of your bonds caused by changes in interest rates. Your priority may instead be to assure the credit quality of your investments.

With bond funds, price fluctuations in net asset value (NAV) will generally occur in response to changes in interest rates and credit quality. For example, increases in interest rates will generally reduce the NAV of bond funds.

Additionally, NAV may be affected by overall flows into or out of a fund. Record inflows into bond funds forced portfolio managers to put cash to work in a low interest rate environment and some opine that if those same inflows reverse course, portfolio managers could be forced to sell bonds to meet redemptions. Additionally, because portfolio managers rarely hold underlying bonds to full maturity, bond funds are a collection of bonds with varying maturities that often change. Portfolio managers may cycle through bonds to maintain a certain yield or average duration, to take advantage of better opportunities, or to accommodate cash for flows in and out of the bond fund. Unlike with individual bonds, an investor in bond funds does not have the option to hold bonds to maturity to collect par value.

It is important to understand that there are tradeoffs with every decision you make in your portfolio. You may find yourself trading one risk for another. For example, when considering a reduction of interest rate risk in your portfolio, you may give up yield by holding similar quality shorter-term bonds. Higher-yielding bonds of similar maturities generally present higher credit risk. Non-dollar investments, such as foreign bonds, carry currency risk as well as geopolitical risks. Diversifying the risk components of your portfolio and matching them to your personal circumstances will be critical moving forward.

If you own individual bonds, your advisor can run an analysis of the bonds you own and quantify the potential impact of rising interest rates on the value and total return of your bonds.

Step 2: Assess possible outcomes with bonds

To get a better understanding of how certain risks might impact your investments, you can work with your advisor to forecast "What if?" scenarios and gauge your comfort level with different possible outcomes. If you own individual bonds, your advisor can run an analysis on the specific bonds you own to assess their credit quality, exposure by credit rating and diversification across issuers. He or she can also quantify the potential impact of rising interest rates on the value and total return of your individual bond holdings.

Together, you can determine whether your current holdings are aligned with your investment objectives or if changes may be prudent.

Step 3: Implement strategies to manage risks

While we do not recommend dramatic changes to fixed income allocations based upon day-to-day market movements, there are a number of strategies available that may help manage long-term risks.

We've presented a number of these strategies in the following tables, based on whether you'd like to maintain your fixed income exposure and manage risks within that portion of your portfolio or reallocate a portion of your fixed income holdings elsewhere.

MANAGE RISKS WITHIN INCOME-INVESTING ALLOCATIONS

RISK	STRATEGY	POTENTIAL BENEFITS	POSSIBLE TRADEOFFS[3]
Interest Rate Risk	**Shorten average duration** Shorten the average maturity of your bond holdings to reduce sensitivity to interest rate movements	• Lessen potential price declines if rates rise. • Allows for reinvestment of proceeds from maturing bonds into potentially higher yielding bonds at an earlier date than if longer maturity bonds are held	• Accepts lower yield
	Purchase premium or higher coupon bonds	• Higher cash flows to meet needs • Tend to be less volatile in a rising rate environment	• Greater initial investment required • A prorated portion of the amount over par can be deducted yearly on the purchaser's tax return or an investor can declare a capital loss when the bonds are redeemed at maturity or sold for a loss
	Yield curve positioning / diversification[1] Yield curve positioning may help under various interest rate scenarios.	• May help protect principal and generate additional return in a rising interest rate environment and allow an investor to capture higher yields	• Yield curve changes may be difficult to predict • If yields rise by the full amount that the markets predict, the benefits of this strategy could be nullified
	Invest globally[2] Invest globally by seeking sovereign and corporate debt in both developed and emerging countries. May best be achieved through professional management	• Not every country will experience the same monetary policy as the U.S.	• Currency fluctuations • Political and credit risks in other countries
	Bank loan, floating rate bonds, high-yield and other specific bond sectors	• Some sectors of the bond market are less sensitive to interest rate risks and allow investors to accept different risks	• Higher credit risks, including greater risk of default, not appropriate for all investors • Lower current yield on floating rate instruments • Floating rate securities may decline in value if their interest rates do not rise as much as interest rates in general
Credit Risk	**Manage credit quality** Minimum "A" rating for municipal bonds. Investment grade or higher for corporate bonds and preferred securities	• Match risk and return with your needs, goals and overall risk tolerance	• All other things equal, higher rated bonds generally feature lower yields than bonds with lower ratings
	Diversify holdings among issuers Maximum of 5% concentration per issuer, state or sector	• Limit risks of a single issuer downgrade or default creating large losses for the overall portfolio	• Ongoing monitoring requirements

This strategy offers the potential to offset principal risk in a rising interest rate environment while capturing higher yields. As a bond approaches maturity it will gradually "roll down the curve" toward lower yields each year as it moves closer to maturity.

[1] Monitoring the yield curve is part of the day-to-day responsibility of fixed income managers.
[2] Investing internationally may involve currency fluctuations, political and economic risks.
[3] The purchase or sale of bonds may result in a commission or fee depending on the structure of your account.
Diversification does not guarantee a profit or protect against loss.

MANAGE INCOME INVESTING RISKS THROUGH REALLOCATION			
OBJECTIVE	STRATEGY	POTENTIAL BENEFITS	POSSIBLE TRADEOFFS
Income	**Diversify Income Sources** Reallocate a portion of your fixed income holdings to other income-generating securities (dividend paying stocks, etc.)	Dividends can provide a stream of income and have the potential to grow over time.	Dividends are only paid at the discretion of the board of directors and are junior in standing to bonds in the credit structure in the event of bankruptcy or liquidation. Unlike fixed income with a set term and coupon payments, equities can fluctuate in value significantly.
Total Return	**Reduce fixed income allocation in favor of other asset classes**	Directly reduce exposure to fixed income risk factors.	Requires correctly identifying attractive asset classes and accepting different risks.
Mitigate Equity Volatility	**Look to other low-correlation strategies besides bonds to mitigate equity risk** (Alternative investments, commodities, REITs)	Asset classes that have historically exhibited low correlation may play a role in mitigating the volatility of the equity markets in portfolios.	Correlations are not constant over time and strategies may not maintain their low correlation. Alternative investments may carry significant risks. *

Raymond James Executive Chairman Tom James noted the importance of discussing these risks with your financial advisor now and taking the necessary steps to ensure you're well positioned for any scenario.

"Investors can't afford too much principal risk in the 'safe' part of their portfolios. Thus, increase bond quality and shorten average bond durations. 'Reaching for yield' has resulted in some investors investing in below investment-grade securities, when spreads over governments are near record lows, which could engender large undesirable outcomes in a rising interest rate environment. … We clearly are in an environment where the passage of time increases the risk of a recovery in interest rates to more normal ranges. … The decisions you make today will affect portfolios in 2014 and 2015 and thereafter." –Tom James, Executive Chairman, Raymond James Financial (03/05/13)

REVISIT INCOME GOALS AND STRATEGIES

Given the likelihood of rising interest rates in the future, concerns over credit quality, and growing concerns over liquidating in bad markets, investors have good reason to reassess fixed income holdings in the near future. In view of where we are in the interest rate cycle and the broader economic recovery, now is an opportune time to evaluate your fixed income investments and determine if action is warranted. While drastic changes may not be necessary in your portfolio, it is important for you to work closely with your advisor, evaluate your circumstances and take action when appropriate. Your financial advisor possesses the tools, resources and expertise to help you make informed decisions.

WORK WITH YOUR FINANCIAL ADVISOR

Understand the products you own and the risk profile associated with each ▶ Reaffirm why you own fixed income and the role it plays in your overall portfolio and financial plan ▶ Re-evaluate your risk tolerance and understand the risks currently facing fixed income investors ▶ Forecast potential scenarios and the impact on your portfolio ▶ Identify and implement appropriate strategies to manage risks

*Asset allocation and diversification do not ensure a profit or protect against a loss. Investment suitability must be determined for each individual investor. Investing involves risk and investors may incur a profit or loss.

This information herein was obtained from sources which we believe reliable, but the accuracy of which cannot be guaranteed. No representation is made that it is accurate or complete, that any returns indicated will be achieved, or that you should rely on it to make an investment decision. Changes to assumptions may materially impact returns. Past performance is not indicative of future results.

Alternative investments involve specific risks that may be greater than those associated with traditional investments and may be offered only to clients who meet specific suitability requirements, including minimum net worth tests. You should consider the special risks with alternative investments including limited liquidity, tax considerations, incentive fee structures, potentially speculative investment strategies, and different regulatory and reporting requirements. You should only invest in hedge funds, managed futures or other similar strategies if you do not require a liquid investment and can bear the risk of substantial losses. There can be no assurance that any investment will meet its performance objectives or that substantial losses will be avoided.

Raymond James financial advisors do not render advice on tax or legal matters. You should discuss any tax or legal matters with the appropriate professional.

There are numerous risks you should be aware of when investing in fixed income. For detailed information on factors to consider when investing in bonds, visit:
http://raymondjames.com/fixed_income_bond_investing_risks.htm.

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