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Should You Play The Bond Rally?

With Economic Outlook Uncertain, Experts Advise Investors to Consider Buying Shorter-Term Issues

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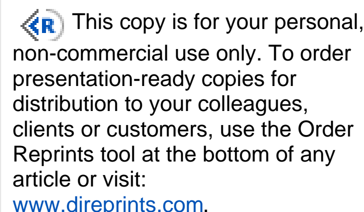

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The recent bond market rally has left many investors wondering how best to get a piece of the action now. The answer, experts say, is to diversify among a range of relatively short-term investments.

That approach, they say, allows investors to hedge against various scenarios -- important at a time when views on the economic outlook are sharply divided. Part of Wall Street is betting that recession is in the cards, which will drive yields lower. (Bond yields move inversely to bond prices, so when investors bid up prices, yields fall.) Others think inflation is the next major economic issue. That would push yields higher as investors dump bonds. (Inflation eats into bond returns.) For investors planning their income needs for the next three to five years, or investors seeking to maintain a diversified portfolio of stocks and bonds, the dueling scenarios create little more than confusion.

Experts say the solution is to diversify your bond-market bets over an array of short- and medium-term maturity dates -- a technique called laddering. This strategy allows you to pick up a decent yield while being largely protected from the bond market's swings. And they recommend the shorter term because currently, it's paying better than long-term holdings. Yesterday, the benchmark 10-year Treasury note had a yield of 4.59%, compared with an average yield of nearly 5% on money-market mutual funds.

YIELD PLAY

Experts recommend that investors diversify their fixed-income investments to hedge against bond-market volatility.

- Buy an array of shorter-term bonds and CDs to maximize yield and minimize risk, a technique called "laddering."
- Search online for the best rates on CDs, money-market and savings accounts.
- Focus on short-term bond mutual funds with low fees.
- Consider municipal bonds if you're in a high tax bracket.

By buying bonds with maturities of up to five years, you get "all the yield and a lot less of the risk," says Steve Bohlin, who manages several bond funds for Thornburg Investment Management.

The dilemma is a turnaround from the recent past, as 10-year Treasurys were above 5% for much of the spring and summer. This prompted many investors to lock in longer-term yields. Now, those yields have slumped again as investors have bid up prices, putting them at roughly the same level of about a year ago.

To be sure, this downtick in Treasury yields could be temporary, as some market experts expect. A string of even mildly encouraging economic reports could quickly reverse the trend and bond yields could once again move above 5%. Indeed, a favorable consumer-confidence report yesterday hurt bond prices, driving yields slightly higher.

In building a fixed-income ladder, you are essentially hedging against the various scenarios. The low

rungs on the ladder -- the short-term investments -- give you quick access to your money in the event rates begin to rise again. As a three-month or six-month CD or a one-year Treasury bill matures, you can roll that money into higher-yielding investments, assuming yields are higher. If they're lower and you have no choice but to accept a lesser yield, well, that's where the ladder's higher rungs are beneficial -- you're locked into higher, more attractive rates for several more years.

"We're doing a lot of laddered bonds," says Larry Heller, a financial planner in Melville, N.Y. "We don't know what way rates are going to go, so we're laddering out between one and seven years," meaning owning bonds that mature at various intervals along that time span.

For investors more accustomed to owning bonds, those with maturities of between one and three years are the most attractive at the moment. If the Fed does next cut rates, "you'll get a nice pop" in the value of those particular bonds, says Carl Kaufman, manager of the Osterweis Strategic Income fund. That's because a rate cut pushes up the price of existing bonds.

For investors who buy bonds through bond funds, pay close attention to fees, says Morningstar analyst Scott Berry. The yields on short-term bond funds fall within a narrow range, and the cost of a fund is often the factor that separates the best from the worst. Some short-term funds that score high with Morningstar include the Fidelity Short-Term Bond and Vanguard Short-Term Bond Index funds.

Experts caution investors to be wary of bonds stretching out past five years. The relatively low yield does not adequately compensate you "for the inflation risk you're taking," says Mr. Bohlin, the bond fund manager.

What makes the current environment so quirky for investors is that short-term rates are substantially meatier than long-term rates -- what's known as an inverted yield curve. Typically, investors are paid more to take on the added risks inherent in a longer-term investment. But today, 10-year Treasurys are at 4.59%, the two-year note is at 4.7% and the three-month bill is nearly 4.9%. And the rate on overnight bank loans, set by the Federal Reserve, is at 5.25%.

For income investors, that's making the yield on money-market accounts, CDs and even a lowly savings account seem rich by comparison.

Online brokerage firm **Charles Schwab** & Co. is advertising a three-month OneSource CD that sports an annual yield of 5.3%. Principal Bank, a unit of **Principal Financial Group**, is offering an online savings account paying 5.26% for balances of at least $25,000; that account gives you immediate access to your money without penalty. **Zions Bancorp**, in Salt Lake City, is paying 5.24% for an Internet-based money-market account with a balance as small as $1,000.

E-Loan Inc., meanwhile, offers a one-year CD yielding 5.70% on minimum deposits of $10,000. Go out two, three, four or five years, and that rate is 5.75% for each period.

"There is a ton of value in boring, old CDs," says Marilyn Cohen, president of Envision Capital Management, a Los Angeles bond investment firm.

Money managers also are looking for income in alternatives to traditional bonds and cash accounts, though none are suggesting that investors load their portfolio with these investments. Instead, "sprinkle a few in to boost your yield," says Ms. Cohen, who has recently been dabbling in so-called callable agency debt from **Fannie Mae** and the Federal Home Loan Bank. Callable bonds can be redeemed by the company or government agency at various points before the bond matures. Companies often call in these bonds when prevailing rates are lower than the bond's stated interest rate. Ms. Cohen over the summer bought some callable debt issued by the Federal Home Loan Bank yielding 6%. But it's callable next

summer, and she expects the bonds will be called in.

"But for about a year, I'm getting a 6% yield, and that's nice," she says.

For fixed-income investors in a high tax bracket, Ms. Cohen says municipal bonds still make a lot of sense. Investors in the 35% tax bracket can pocket a tax-equivalent yield of 5.58% going out just three years in double-A rated municipal bonds.

Bob Mecca, a financial planner in Mount Prospect, Ill., is also buying callable agency debt for his clients. The agency bonds are triple-A rated, so they are safe. The risk, he says, is that the bonds aren't called, meaning that it's likely prevailing rates have moved higher and you're stuck earning lower rates. And if you sell, you risk a capital loss if the bond's price is below where you bought it.

Mr. Heller, the planner, is also looking to dividends to beef up income for his clients. He's looking to the **iShares Dow Jones Select Dividend Index** fund, an exchange-traded fund, currently yielding about 3.4%; and the Alpine Dynamic Dividend fund, currently yielding about 13%. The risk with this strategy for income investors is that if stock prices tumble, it shrinks the value of the investment.

"We're adding this to our laddering strategy," says Mr. Heller, "because rates are going lower and this is another way to get clients some income."

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