Traps for Bond Investors Now—and What To Do

Sometime in the next few months or years, today's very low interest rates will start to surge. As a result, the value of bonds that investors already own will sink. Bond investors got a taste of this in May, when 10-year Treasury bonds rose to 2.16% from 1.66%, causing the iShares Core Total US Bond Market exchange-traded fund (ETF) to drop 2% in price. Some bond ETFs lost about 8% or more. Bond prices sank further in June after Fed Chairman Ben Bernanke said the Fed's massive bond-buying program may be scaled back starting later this year and possibly ended by mid-2014.

To uncover today's hidden traps for bond investors, we spoke with bond expert Paul Winter, CFA, CFP…

TRAP: Rebalancing your portfolio in the traditional way. For most investors, that would mean paring back stock investments after the kind of big run-up that the stock market has seen over the past few years…and ratcheting up bond investments. But bonds are more overvalued than stocks now and could be for the next several years to come.

What to do instead:Take some profits in stocks, but use the cash from those sales to invest in areas of the stock market that are relatively undervalued now—not bonds. These include Japanese stocks, such as those in the WisdomTree Japan Hedged Equity ETF, and stocks of the very biggest US companies, such as those in the iShares S&P 100 Index ETF.

TRAP: Loading up on Treasury Inflation-Protected Securities (TIPS) to prepare for a surge in inflation.TIPS are bonds issued by the US Treasury designed to keep up with inflation. Historically, these bonds have been a good value when they have offered a real return of more than 2%. But TIPS have been in such great demand in recent years that yields have sunk.

Recently, five-year TIPS offered a return composed of the rate of inflation plus a yield of negative 0.82%. In other words, your return is guaranteed not to keep up with inflation. If inflation runs 3%, your rate of return on the bond would be just 2.2%—which is more than the recent yield on five-year Treasuries but less than that inflation rate. There are no signs of heightened inflation now, and I expect inflation to remain low for the next several years. *Additional risk for investors in TIPS mutual funds:*If interest rates jump while expectations for inflation don't, the fund could drop in price.

What to do instead:If you already own individual TIPS, sell them to lock in the big gains that they've made over the past few years—before their price gains erode. Reinvest some of your profits in commodities, which have been in a two-year bear market but are likely to soar if inflation heats up.

My favorite way to invest in commodities now…

iPath DJ-UBS Commodity Index ETN(DJP) tracks the prices of 22 commodities.

TRAP: Switching to short-term bonds to protect your portfolio from market volatility and a spike in interest rates. Even though bonds with shorter maturities tend to suffer less when interest rates jump, they are not attractive now. Yields are painfully low on short-term Treasuries and on high-quality corporate bond funds that have average durations—a measure of their sensitivity to interest rate increases—of less than three years. *Example:*Barclays Capital 1-3-Year Treasury Bond Index recently yielded just 0.1%.

What to do instead:Invest in high-quality mortgage-backed securities. These are large pools of residential home mortgages packaged together and sold like bonds. The principal and interest payments on the mortgages are passed along to the investors. These payments are well-protected because these securities have been backed by the federal government since the 2008 financial crisis. Their short average durations have historically made them one of the top bond asset classes to own in a rising interest rate environment, and they pay higher interest rates than Treasuries.

My favorite way to invest in mortgage- backed securities now…

iShares Barclays MBS Bond ETF(MBB), which invests in mortgage-backed bonds issued by Fannie Mae, Freddie Mac and Ginnie Mae, recently yielded 2.7%. Even in the 2008 market storm, it returned 8%. *Recent share price:*$106.28.

*Caution:*Mortgage-backed bonds do carry a special sort of risk that makes them less safe than US Treasuries. If interest rates plunge in the future, home owners could refinance, in effect returning your principal to you earlier than you expected and forcing you to find someplace else to invest your money. But I like these bonds now because the chances of rates plunging from current levels are remote.

TRAP: Taking big risks to get higher yields. This includes…

High-yield (junk) bond funds,which pay higher rates because they hold the bonds of issuers with serious credit-quality problems. These funds have attracted so many investors over the past four years that prices have soared and yields have sunk to the 5% range. They're no longer worth the risk, considering that these funds could lose 20% or more if the economy falters—as it did in 2008, when the Barclays Capital High Yield Index fell 26%.

Emerging-market bond funds,which hold government debt of developing nations. Net assets put into this fund category increased by more than 40% in 2012. But these bond funds, which recently yielded about 4%, on average, are tricky to own. After appreciating by an average of 20% last year and about 10% annually over the past five years, they are expensive, and unless you invest in a fund in which the bonds are denominated in US dollars, you risk big performance swings from fluctuations in local currencies.

What to do instead:To get a competitive yield without taking on huge risk, I am using floating-rate bank loans. These are pools of loans that banks make to companies. Their current yield is 2% to 3%. They are tied to short-term interest rates, which typically reset every 90 days. So if interest rates rise, so does the yield.

My favorite floating-rate bond fund now…

Fidelity Floating Rate High Income(FFRHX), a conservative fund with a recent yield of 2.3% and an average credit quality of BB. *Five-year performance:*5%. www.Fidelity.com

TRAP: Investing in target-date funds that have a large bond component. Many of these funds, which increase their proportion of bond holdings and reduce their proportion of stocks as the target date (typically your retirement year) approaches, could suffer sizable losses if interest rates jump and bond prices plunge.

*Example:*The Wells Fargo Advantage Dow Jones Target 2015 Fund has 60% of its portfolio in bonds with an average duration of 5.9 years, which could mean a drop in value of nearly 6% if interest rates rise by one percentage point.

What to do:If you own shares in a target-date fund and may need to draw on this asset in less than 10 years, consider moving some of the money into lower-risk target-date funds or other lower-risk investments now.

*Example:*The American Funds Target Date Retirement 2015 Fund has just 31% of its assets in bonds, with a relatively short four-year average duration. That means if interest rates rise one percentage point, the value of the bond portfolio would likely fall just 3.8%.

*Helpful:*For target-date investors who don't expect to tap their retirement portfolios for more than 10 years, sit tight. Even in a rising interest rate environment, the short- and intermediate-term bonds in your target-date fund still will be less volatile than stocks.

THE TWO-BUCKET STRATEGY

In the current low interest rate environment, my retired clients use a two-bucket strategy. In the first "bucket" goes enough existing cash and reliable cash flow to cover living expenses for two years (including guaranteed sources of income, such as pensions and Social Security, as well as supersafe investments, such as savings accounts and CDs).

Other assets go into a second bucket that consists of investments in a diversified portfolio consisting of dividend-paying stocks and the kinds of low-risk bonds mentioned above.

Each year, Bucket One is replenished with fixed income thrown off by the portfolio in Bucket Two (it currently yields about 3% a year), then by the sale of assets in Bucket Two that have appreciated the most. Even in bad years, some parts of this diversified portfolio typically will see some gains.

The two-bucket strategy has the benefit of avoiding having to sell assets after they've had steep losses, and it makes retirees more willing to endure market volatility knowing that they still will be able to pay their bills each year.

Source: Paul Winter, CFA, CFP, a 20-year veteran of the bond market and founder and president of Five Seasons Financial Planning, a fee-only investment advisory firm based in Salt Lake City with $30 million in assets under management. http://www.fiveseasonsfinancialplanning.com/