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On the money

Crystal ball stays hazy on bonds' safety

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It's a confusing time for bond investors.

One day analysts are fretting over the possibility of more inflation, which could cause bond yields to climb and make investors regret that they bought bonds now instead of waiting for higher-interest bonds later.

On other days the pros are fretting about the opposite -- that the economy could slow down and cause interest rates to drop. Then investors would be happy about having the foresight to have bought bonds before they started paying less interest.

Amid the indecisiveness, an inflation and interest-rate scare sent yields on 10-year Treasuries to the most tempting level investors have encountered since 2002. On June 12, they climbed to 5.29 percent -- a significant move from 4.89 percent at the end of May, and certainly a treat compared with lows below 4 percent a few years ago.

But as investors worried that distressed subprime mortgage investments could infect more than a Bear Stearns hedge fund, and housing news remained gloomy, fear of an economic slowdown became a drag on bonds and yields dropped to 5.14 percent at the end of the week.

Clearly, there is no clarity. Investors cannot decide if they should believe Bill Gross, chief investment officer of the respected Pimco bond fund, who recently said he thinks he underestimated inflation and believes yields on 10-year Treasuries could go to 6.5 percent during the next few years, or side with those fretting about an economic slowdown.

Predicting interest rates is never easy -- even for the savviest economists. And it's even more complex now in an era of globalization. Some argue that a growth spurt outside the U.S. can kindle inflation here and abroad, even if a slowdown in housing construction in the U.S. causes people to lose jobs and hold on to their pocket change. In the past, U.S. bonds would have responded primarily to the U.S. economy. Now the world is more interwoven than in the past. If rates on foreign bonds climb, economists say, the U.S. might be under pressure to raise rates on U.S.

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Treasuries to attract potential foreign investors.

Reading the tea leaves for bonds means peering through a murky worldwide brew.

So what's an investor to do?

First, watch for news on inflation, and realize that if inflation picks up and interest rates climb the bonds you bought today could lose value. If you are an investor who buys safe U.S. Treasuries and CDs, and you hold them until they mature, you won't lose principal -- or the money you invested.

But if you invest in bonds through a mutual fund you could have a loss. It happened in May as yields were trending upward. The Vanguard Total Bond Market Index Fund -- which mimics the full U.S. bond market -- lost almost 1 percent. And foreign bonds in developed markets lost about 2 percent.

If your money will be invested for many years you will come through a temporary loss. If you have shorter-term needs for your money the loss could be more detrimental. Say you have a child about to go to college, and you have money in a 529 college savings plan. If you have directed the plan to invest the money for you based on your child's age you probably have a large portion in bond funds now.

An extended losing period in the bond market could erode your college funds just when you need them most.

So Minneapolis financial planner Michael Hellfrich suggests that parents watch for inflation and rising rates when students are about three years away from college. If there appears to be a potential threat -- as he thinks there may be now -- there is an easy solution.

Hellfrich suggests contacting the 529 plan's fund company and requesting a change for the investments. Simply tell the plan to keep the stock investments invested like they are now. But tell the plan to move the bond investments into a money market fund -- a relatively safe fund that could be yielding about 5 percent now.

Hellfrich tends to keep retirees out of bond funds because they can suffer losses in rising interest rate environments.

Louis Kokernak, an Austin, Texas, financial planner, uses funds for bond investments called exchange-traded funds, or ETFs. They can decline in value if interest rates climb. But recently he has shifted a little more money than usual into ETFs that invest only in bonds that mature within one to three years. He reasons that bonds that mature relatively quickly don't fall as much when interest rates are climbing.

On the other hand, he's not betting everything on short-term bonds. If the economy cools off the yields on today's longer-term bonds could prove to be attractive.

He invests about two-thirds of clients' bond money in an iShares Lehman 7-10 Year Treasury Bond Fund, and another third in the shorter-term fund -- the iShares Lehman 1-3 Year bond fund. For a total bond portfolio, he puts about a quarter to a third into the Pimco Foreign Bond Fund and the rest in U.S. securities, so he is not dependent on the U.S. bond market alone.

Professional bond fund managers also have been concentrating more on shorter-term bonds than they normally would.

David Lippman, a managing director for Metropolitan West Asset Management LLC, says that investors

are not being rewarded enough for the risk of buying longer-term bonds. Two-year Treasuries are yielding 4.97 percent, while 10-year Treasuries were recently 5.13 percent. Yet 10-years will fall hard if interest rates climb.

Lippman also says he is not buying as many corporate bonds as usual because they are yielding little more than Treasuries and could be vulnerable if the economy slows, as he expects it will at some point.

The riskiest of bonds now are high-yield bonds.

"They are junkier today than they were back in the 1990 recession," said Leuthold Group LLC analyst James Floyd. About 20 percent of them are rated CCC or lower, compared with only 2 percent in 1990, because it has been so easy for companies -- even weak ones -- to borrow money.

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