How to pick bonds that won't wither if interest rates go up

BY TODDI GUTNER

WITH AN ECONOMIC expansion well under way, the Federal Reserve is expected by midyear to start raising short-term interest rates from the current, historic low rate of 1%. There's no way this can be a positive for bond investors. After all, when interest rates rise, the prices of outstanding bonds fall: A one-percentage-point rise in interest rates will knock about 8% off the value of a 10-year U.S. Treasury bond.

Still, you shouldn't avoid bonds entirely. Fixed-income securities provide income and offer diversification, offsetting some of the volatility of the stock market. To minimize the damage from the rising rates, you'll need to adopt defensive strategies that include reducing your bond holdings 10% to 15%, or choosing securities with shorter maturities of one to two years. A two-year U.S. Treasury note yields about 1.8%—more than double a three- or six-month Treasury bill—with minimal risk to your principal. Longer-term government securities could be dangerous in 2004, warns James W. Paulsen, chief investment strategist at Wells Capital Management, "because there is no yield buffer against rising rates."

Still, some bond sectors can withstand moderately higher rates:

HIGH-YIELD BONDS

HIGH-YIELD OR junk bonds perform well in a recovery, as better business conditions bolster balance sheets. That means many companies' credit ratings improve, and fewer issuers default. Indeed, the default rate has dropped from nearly 10% of all junk bonds in August, 2002, to just over 5% now. That figure should continue to slide as the economy expands.

Of course, the junk-bond market has been betting on recovery for a while, logging more than 20% total returns (yield plus bond-price appreciation) in the past year. While the high-yield market isn't likely to see a double-digit repeat in 2004, the yield—now around 8.1%—is still high relative to investment-grade bonds. That means junk-bond investors could take a little erosion of their principal and still come out ahead.

The high-yield market encompasses nearly as many sectors as the stock market. Margaret D. Patel, portfolio manager at Pioneer High-Yield Fund, which is rated A by *BusinessWeek*'s Mutual Fund

ILLUSTRATION BY MELINDA BECK

BONDS FOR AN ECONOMIC EXPANSION

BOND SECTOR	AVERAGE YIELD*
High-yield Improved economy means rising credit quality and falling default rates	8.1%
International Pick up as much as 3.3 percentage points over Treasuries—plus currency gains	5.0
Municipals Issuers' financial health is getting better, and tax-free income is always in style	3.5
TIPS Principal adjusts to keep pace with inflation, the bane of bond investors	1.9

Data: *BW* *Dec. 12

Scoreboard, says she's finding good opportunities in bonds from semiconductor companies and issuers in economically sensitive industries such as chemicals, nonferrous metals, and paper and packaging.

You can seek those bonds, but high-yield is an illiquid market better left to the pros. Most individual investors would be better served in a bond fund. Besides Patel's fund, other top-rated funds include Buffalo High Yield and Neuberger Berman High Income.

INTERNATIONAL BONDS

THE WEAKENING DOLLAR means U.S. investors can earn handsome returns from foreign currency exposure in unhedged international bonds. "We're investing in the currencies of developed countries that benefit from world growth and also have yield advantage over the U.S.," says Dan Fuss, co-manager of the Loomis Sayles Bond Fund. Specifically, Fuss likes government bonds from Australia, Canada, Norway, and Sweden, all of which allow investors to pick up yields of 0.7 to 3.3 percentage points over U.S. Treasuries. That means returns of 3.0% to 6.3%—before any currency appreciation.

Although emerging-market debt has had a terrific run the last two years, there is still some benefit to owning these bonds, says Joe Balestrino, portfolio manager of the Federated Strategic Income Fund. For example, 10-year Brazilian U.S.-dollar-denominated debt yields 8.5%, more than four percentage points over Treasuries.

> The weakening dollar means handsome gains can be made in foreign bonds

MUNICIPAL BONDS

TAX-EXEMPT MUNICIPAL bonds provide a better haven than Treasuries when rates rise. Because munis didn't rally as much as Treasury bonds in the recent bull market, they aren't as likely to fall as far when rates rise, says Mary Miller, assistant director for fixed-income at T. Rowe Price. Munis also tend to be less volatile than Treasuries because the market is dominated by individuals, who buy and hold, rather than by institutional investors, who constantly trade bonds.

The strengthening economy also bolsters munis because it improves issuers' financial health. Indeed, tax revenues are running ahead of budget in many states. "The worst is behind us, and many states have turned the corner by cutting spending, raising taxes, and budgeting more conservatively," says Miller.

The best case for munis is, as always, the tax-free income. Assuming a combined 38% state-and-federal tax rate, a current 3.5% yield on a 10-year, AAA bond is the equivalent of a 5.6% taxable yield.

TIPS

INFLATION IS ONE of the major drivers of rising interest rates, and there's no better protection than Treasury Inflation Protected Securities (TIPS). The notes pay a 1.8% coupon, and then adjust the principal twice a year for inflation as measured by the consumer price index.

To know whether TIPS make sense, though, you have to compare the yield with that of fixed-rate Treasury bonds. For instance, 10-year TIPS yield 1.9%, compared with 4.2% for 10-year Treasuries. So why is the lower-yield inflation bond better? Subtract the TIPS yield from the Treasury's, and you get about 2.3%. What that means is if the annualized inflation is higher than 2.3% (today's rate is 1.8%) over the life of the bond, TIPS will outperform the Treasury. That's a good bet. The long-term average inflation rate is around 3%. ■

Q&A
KATHLEEN C. GAFFNEY

Kathleen C. Gaffney has co-managed the $1.9 billion Loomis Sayles bond fund since 1997 and the $326 million Strategic Income fund since 1996. She works with veteran fund manager Dan Fuss. Gaffney spoke recently with Associate Editor Toddi Gutner.

What do you expect from the Federal Reserve?
The big question is not whether the Fed will raise interest rates, but when and by how much. We expect the Fed to raise rates 75 basis points by the end of 2004. It's likely to raise rates later rather than sooner because the Fed needs to make sure not only that the U.S. is on its feet but that the rest of the world is, too. A lot of strength is coming from Asia right now. It's a little too hot. If Asia slows, the Fed won't want to tighten [right away].

What bonds do you like?
The best opportunities are in the government bonds of Canada in the three-to-five-year range, as well as the long-term bonds that pay [returns] in Australian and New Zealand dollars. We can pick up anywhere from 0.7 to 3.3 percentage points. As money flows into these markets, it's bullish for the currency as well. We also tend to like high-yield bonds.

So you don't think the junk-bond market is overheated?
True, the high-yield market has had quite a run over the past year, but we still see value there. We think you should be able to earn your coupon this year, despite rising rates. Last year's story was fallen angels. This year, given the improving economy, we'll see a number of rising angels such as J.C. Penney, Qwest Communications, and [global power company] AES. Rather than targeting industries, we're more company specific.

What sectors are you avoiding?
Very high-quality U.S. corporate bonds [rated A and above] moved quite a bit last year. That makes the yield advantage relative to Treasuries almost nonexistent, and therefore they're very sensitive to changes in interest rates.